UBS

Global Equity Research

South Africa

Insurance, Life

UBS Investment Research
Discovery Holdings Ltd

12-month rating	**Buy**
	Prior: Not Rated
12m price target	RCnt3,950/US$5.71
Price	RCnt2,272/US$3.28

RIC: DSYJ.J BBG: DSY SJ

11 January 2008

Vitality gives Discovery life

- **Vitality enhances all business units**

We believe Discovery's wellness programme, Vitality, is the core reason for: (1) its superior life insurance profitability; (2) its dominant broker market share (c32% of broker risk business); (3) the competitiveness of the Discovery Health Medical Scheme (DHMS); and (4) its international growth prospects. It is also virtually impossible to replicate Vitality in the South African market.

- **Regular experience profits to continue**

Regular experience variance profits have added some cR1bn to Discovery's embedded value over the past five years (c5% of value in-force pa) and we expect this to continue. Capitalising this could add up to 36% to the Life VIF (25% to the Health). The reported embedded value is therefore possibly understated.

- **Health virtuous cycle**

Discovery is the largest medical scheme administrator in South Africa (c28% of the market). Its size gives it strong negotiating power with providers (hospital groups), which in turn reduces its claims cost, which reduces premium increases, and increases its competitiveness.

- **Valuation: Initiate with Buy rating, SOTP-based price target of R39.5**

The share is trading at c0.75x our one-year forward adjusted NAV. Our sustainable ROEV of c19% should warrant a premium to its adj NAV of up to c47%. It is our top pick in the sector because of its superior ROEV to other insurers and relative trading discount (others trading at c0.9x with ROEVs of c14-16%).

Highlights (Rm)	06/06	06/07	06/08E	06/09E	06/10E
Pre-ex PBT	917	886	1,004	1,168	1,441
Net Income (UBS)	507	688	614	720	895
Pre-ex EPS (UBS, RCnt)	99.63	165.13	186.40	216.83	267.47
Reported EPS (RCnt)	115.85	196.31	196.40	230.36	286.37
Adj NAV/share (UBS, RCnt)	1,786.88	2,097.29	2,609.65	3,317.55	4,072.77

Profitability & Valuation	5-yr hist av.	06/07	06/08E	06/09E	06/10E
Adjusted ROE %	-	20.8	19.1	19.1	19.0
ROE %	-	14.4	10.6	11.5	13.0
Pre-ex PE (UBS) x	-	16.1	12.2	10.5	8.5
PE x	-	13.6	11.6	9.9	7.9
P/Adj Nav x	-	1.3	0.9	0.7	0.6

Source: Company accounts, Thomson Financial, UBS estimates.
Valuations: based on an average share price that year, (E): based on a share price of RCnt2,272 on 07 Feb 2008 21:37 GMT

Michael Christelis
Analyst
Michael.Christelis@ubs.com
+27 11 322 7320

Trading data (local/US$)

52-wk range	RCnt3,315-2,272/US$4.77-2.94
Market cap.	RCnt13.4bn/US$1.94bn
Shares o/s	592m (ORD)
Free float	45%
Avg. daily volume ('000)	119,426
Avg. daily value (RCntm)	3,279.3

Balance sheet data 06/08E

Shareholders' equity	R6.21bn
Financial debt	R0.07bn
Total invested assets	R4.89bn

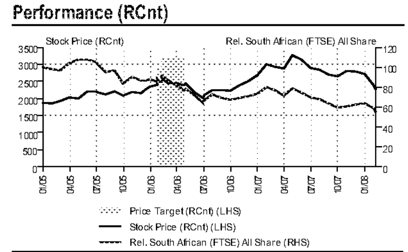
Forecast returns

Forecast price appreciation	+73.9%
Forecast dividend yield	2.0%
Forecast stock return	+75.9%
Market return assumption	13.7%
Forecast excess return	+62.2%

EPS (UBS, RCnt)

	06/08E			06/07
	From	To	Cons.	Actual
H1E	-	98.20	-	98.16
H2E	-	98.20	-	98.16
06/08E	-	196.40	*203.80*	
06/09E	-	230.36	*258.80*	

Performance (RCnt)



Source: UBS

www.ubs.com/investmentresearch

Michael Christelis
Analyst
Michael.Christelis@ubs.com
+27 11 322 7320

Contents

page

Investment thesis

The Vitality advantage

We believe that Vitality gives Discovery a unique advantage in the South African financial services industry that is near impossible to replicate and significantly enhances all parts of the group. Vitality provides Discovery with a platform to expand into mature, often saturated, markets and gain market share. We believe that Vitality provides superior life insurance margins and medical scheme membership growth potential (despite its already large size) through selection effects, significantly lower mortality claims, health claims and lapse experience, and a brand of its own that has become a household name in the affluent market in South Africa. Vitality's scale, by virtue of its c60% penetration of DHMS (the largest medical scheme in the country), enables it to negotiate benefits for its members that are better and cheaper than those offered by competitors.

We initiate coverage with a Buy rating and a price target of R39.5. We believe the stock has been oversold because of the overhang from the unbundling from the FirstRand group, and because of the lack of clarity on the future of Destiny Health in the United States. The share price is currently c0.8x our 1-year adjusted NAV, with a sustainable ROEV of c19%.

Key positives

- **Vitality effect:** The impact of Vitality is core to the group as a whole. We believe the Vitality program benefits all areas of the group, responsible for the significant regular positive experience variances (consistently c5%p.a. of the VIF, typically life insurance experience variances are <1% of the VIF and may be positive or negative). We believe that this program is exceptionally difficult to replicate or compete with. We believe Vitality provides Discovery with the ability to expand offshore (as it has with the Prudential JV where it has attracted c142k members in the UK) due to the lack of similar technology or know how internationally. Vitality also offers Discovery, in our opinion, the only viable option for the beleaguered Destiny business.

Vitality is the key advantage for Discovery

- **Discovery Life growth/margins:** We believe Discovery Life is the fastest growing life insurance provider (by sales volumes) in the South African market (albeit off a low base). Discovery Life is the largest "pure risk" product writer in the independent financial advisor space in South Africa writing c32% of broker risk business. It is also the most profitable of the insurers we cover, with API margins in excess of 50%, compared to the c16% for Old Mutual's and Liberty's and c17% for Sanlam's individual life insurance businesses.

The fastest growing life company in South Africa along with the highest API margins

- **Health administration virtuous cycle:** We believe that its market dominance (c28% of medicals scheme members in South Africa are on Discovery plans) provides superior negotiation ability. We believe that Discovery fills c26% of all private hospital beds in South Africa, which has led to stronger negotiation ability, resulting in lower tariffs (we believe as low as 10% lower) being negotiated with the private hospital networks, than

The largest medical scheme administrator

its competitors. This should ultimately lead to lower premiums per member, and increased competitiveness, which in turns leads to higher new entrants, and membership which in turn continues to increase its bargaining power with the hospital networks (ie, a virtuous cycle).

- **Offshore upside not taken into account:** We have not allowed for any value in our SOTP valuation for PruProtect in the UK, and have adopted a cautious negative value for the Destiny business (equivalent to c2x annual salary costs plus the discounted value of the next three years' operating losses). We believe that there is potential additional upside, should these businesses become profitable. Further, we believe that the lack of clarity on Destiny is weighing heavily on the share price. Particularly in light of comments made by CEO Adrian Gore in September 2007 that the finalised strategy would be communicated in October 2007. An announcement should be welcome by investors and may result in some re-rating.

We have modelled Destiny on a worst case scenario

- **Valuation:** Significant upside. Our SOTP-based price target of **R39.5** provides some 75% upside from current price levels (R22.7 on 7 February 2008). We believe that this value is in fact cautious because we have not ascribed any value to the PruProtect business and a negative value to Destiny in the US.

Possible significant upside to our price target

Key risks to the valuation

The three key risks to our valuation are as follows:

- **Discovery Life:** New business growth that is worse than our expectation of 15% for 2008 or sharply declining margins would reduce our forecast embedded value as well as franchise value for the life business, the largest components of the group's appraisal value

The valuation is sensitive to new business flows

- **Discovery Health**: Regulatory intervention to reduce target medical scheme administration fees to lower than the 10% that Discovery is targeting would affect the embedded value of the health business.
- **Destiny Health:** Failure by management to promptly provide clarity to shareholders on the future of this business would, we believe, weigh heavily on the stock price. We believe that this is one of the key reasons for the lack of appetite for this share.

Investors want an answer on Destiny... sooner rather than later

Catalysts

Key short-term catalysts for this stock are:

- The removal of any overhang that may have arisen from the FirstRand unbundling (timing is uncertain, we believe it is imminent, see section on 'stake ownership' below)
- H1 08 interim results announcement (27 February 2008)
- An announcement regarding the future of the beleaguered Destiny Health business (timing uncertain, possibly at the interim results announcement)

Stake ownership

Liquidity increased post the unbundling

In November 2007, Discovery Holdings was unbundled from the FirstRand group. FirstRand previously held 57% of the group's shares. This, along with the company director's holdings and empowerment and staff trusts, left an effective free float of only c19%. We believe that after the unbundling, this free float has effectively risen to c45%. Our analysis shows that the overhang from the unbundling may well be out the way by mid-February 2008.

UBS versus consensus

We are lower than consensus on earnings, but happy to be cautious on Destiny and PruProtect

Table 1 shows our forecast adjusted earnings per share versus consensus as per Bloomberg's. We are c4% and c16% behind consensus earnings, for FY 08 and FY 09 respectively, which we expect is probably due to our cautious stance on the future of Destiny and the success of PruHealth and PruProtect.

The other sell-side analysts (4) that cover this stock have rated the stock as 'buy', 'overweight' or 'outperform'.

Table 1: UBS earnings estimates versus consensus

(R¢)	2008E	2009E
Consensus adj EPS	206	276
UBS	197	231
% Difference	-4%	-16%
Consensus DPS	45.5	56.6
UBS	41.7	48.3
% Difference	-8%	-15%

Source: UBS estimates, Bloomberg

Valuation

We value the Discovery group on a SOTP appraisal value basis. We have used valuation methodologies consistent with the valuations of other insurers we cover (see the last column in Table 2). Our detailed valuation is in Table 2.

We use a consistent SOTP basis

Table 2: SOTP valuation summary

	2008E	2009E	2010E	Valuation methodology
Life business VIF	7,467	9,315	11,393	UBS forecast VIF
Discovery Health VIF	4,733	5,016	5,307	UBS forecast VIF
Life franchise value	4,509	4,960	5,456	c6X forecast VNB
Health franchise value	197	195	199	c3x forecast VNB
Balanced portfolio	3,090	3,897	4,996	Marked to market projected forward
Risk adjustments	(1,355)	(1,554)	(1,775)	Adjust risk margins to 4%
BEE notional loan amount	1,039	1,153	1,270	Projected value
Discovery Invest	543	631	699	Discounted cash flow
Vitality	489	506	524	Discounted cash flow
PruHealth	889	977	1,075	Discounted cash flow
PruProtect	-	-	-	
Destiny	(445)	(382)	(365)	5x projected losses
Total (adjusted for risk margins)	21,154	24,708	28,765	SOTP
Shares in issue at year-end (m)	591.95	591.95	591.95	Fully diluted number of shares
Per share	35.74	41.74	48.59	

Source: UBS estimates

Price target

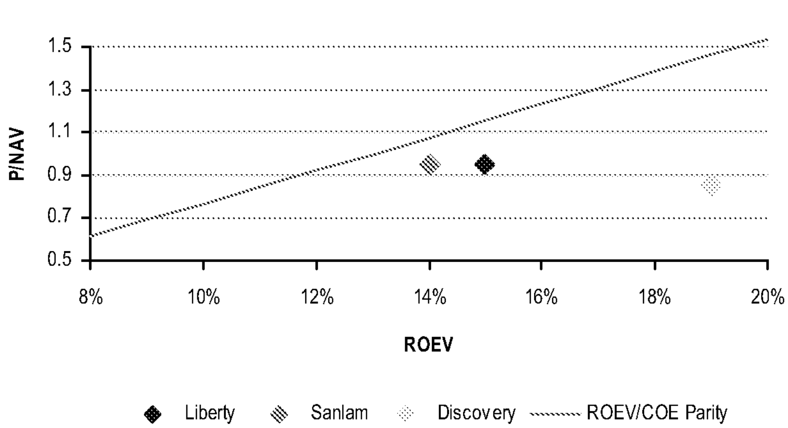
We initiate coverage with a Buy rating and a price target of R39.5. Our price target is derived from the SOTP valuations in table 2.

Price target of R39.5

Our price target implies a value for Discovery of c1.3x our 1-year adjusted NAV. This is higher than our valuation for Sanlam and Liberty because of Discovery's superior ROEV and future earnings growth. Chart 1 shows the market price to our one-year adj NAV and the sustainable ROEV of each company. The COE/ROEV parity line shows the valuations using a COE of 13%, and the P/Adj NAV equal to the ROEV/COE. Discovery is trading at a deep discount to this line.

Discovery appears oversold on a price-to-adj NAV basis, more so than others

Chart 1:Industry price to December 2008 adj NAV



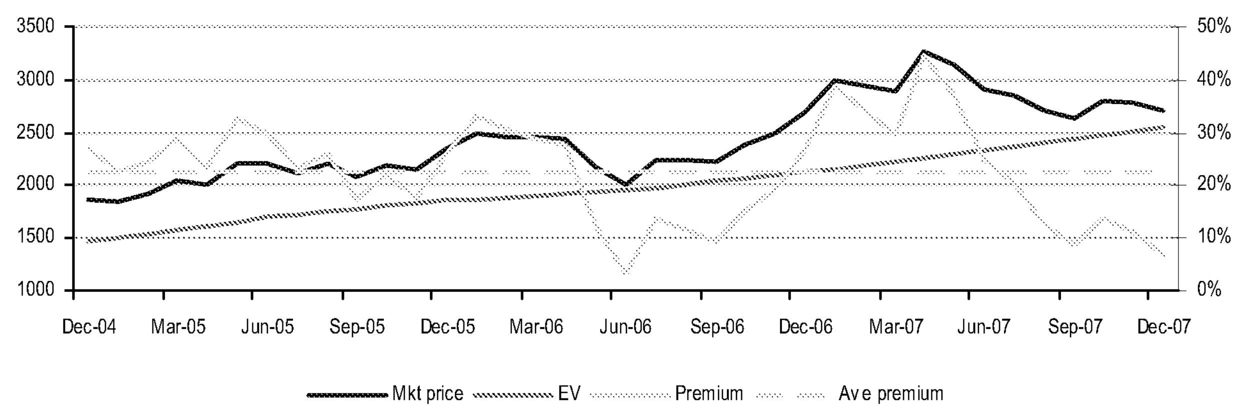
Source: UBS estimates

Our one-year price target of R39.5 represents a premium of c30% to our fully diluted one-year embedded value per share of cR30. The share price has historically traded at an average premium of 22% to the share price (see Chart 3).

We believe a higher premium to EV is warranted by business mix change

We believe that the higher premium is now warranted because the group's business mix has shifted towards the highly profitable life business, and away from the less profitable health business. Our life business VIF valuation now constitutes c51% of the total SOTP, and grows to c54% in the next three years (total life business is c65% of the SOTP if we include the balanced portfolio).

Chart 2: Market price to embedded value premium/discount



Source: UBS estimates, I-Net Bridge

Sensitivity analysis

Our valuation is sensitive to new business multiples

The largest subjective component of our valuation is the new business franchise value, so we asses the sensitivity of our appraisal value to various new business multiples. Table 3 shows the impact of different levels of life new business multiples on the valuation of the group as a whole.

Table 3: Sensitivity of our 30 June 2008 valuation to new business multiples

	Life VNB multiple	Life franchise value (Rm)	Total group valuation (Rm)	Per share (R)	% change from base
Higher multiple	8	5,913	21,518	38.23	7%
Base case	6	4,509	20,114	35.75	
Lower multiple	4	2,957	18,563	33.00	-8%

Source: UBS estimates

Earnings

We forecast the earnings of the Discovery Group on an IFRS basis and an embedded value basis.

IFRS forecast

Table 4 shows our summary forecasts on an IFRS basis.

The key features of our forecast are:

- No EPS growth in 2008 as a result of the higher effective tax rate going forward and the lower equity market assumptions for 2008.
- The reduced earnings growth in 2008 is also due to the low growth in the health business earnings as a result of the negotiation with the Medical Scheme Council to reduce administration fees by R3m per month for calendar year 2007 and R1.25m per month for 2008. The reduction in IFRS earnings caused by this equates to cR25m for FY 08.
- Another reason for the poor earnings growth forecast for FY 08 is the increased losses at PruProtect projected for its first year of operation.
- Earnings growth should improve into FY 09 and FY 10 because of forecast sharp reductions in the losses at PruHealth as the business heads towards our forecast breakeven in the second half of 2010.
- The key area for earnings growth going forward, in our opinion, is driven by the growth in Discovery Life and Discovery Invest.

Table 4: Forecast IFRS earnings

(Rm)	2007	2008E	2009E	2010E	2008E/2007	2009E/2008E	2010E/2009E
Discovery Life	1,000	1,039	1,269	1,493	4%	22%	18%
Discovery Health	791	805	864	945	2%	7%	9%
Vitality	58	59	61	66	1%	4%	7%
Discovery Invest	-	5	35	61		562%	76%
PruHealth	(214)	(130)	(76)	(1)	-39%	-42%	-98%
PruProtect	(36)	(116)	(123)	(113)	221%	6%	-8%
Destiny Health	(89)	(89)	(76)	(73)	0%	-14%	-5%
Total	1,510	1,573	1,954	2,377	4%	24%	22%
BEE expenses	(34)	(17)	(10)	(5)			
Finance costs	(21)	(21)	(21)	(21)			
Forex gain - unrealised	3	0	0	0			
Profit before tax	1,458	1,535	1,801	2,238	5%	17%	24%
Tax	(385)	(461)	(540)	(672)	20%	17%	24%
Profit for the year	1,073	1,075	1,260	1,567	1%	17%	24%
Fully diluted EPS (R¢)	196	196	230	286	1%	17%	23%
Headline EPS (R¢)	165	186	217	267	13%	16%	23%
Interim Div (R¢)	16	18	21	26	12%	16%	23%
Final Div (R¢)	21	24	27	34	12%	16%	23%

Source: UBS estimates

Our full detailed forecast IFRS income statement is provided in Appendix 1. The breakdown of operating profit per division is detailed in the section on that division later in this report.

Expect dividend cover to remain at 4.5x

We expect the dividend cover to remain at the current high of 4.5x until such time as the new business growth tapers off. Even then, it may maintain this high cover in order to facilitate expansion into other markets.

Embedded value earnings forecast

Table 5 details our summarised embedded value earnings forecast for the group. Our long term sustainable ROEV for the group is c19%. This is higher than at the other insurers we cover (OML c16%, SLM c14% and LGL c15%) and is, in our opinion, largely driven by the strong new business flows into the life business, and the fact that margins for this business are higher than at the rest of players in the life insurance market in South Africa (See Chart 8).

Once again, the growth in FY 08 is muted due to reduced equity market returns assumed in the embedded value going forward than those in FY 07.

We allow for continued positive variances

Importantly, unlike for the other insurers we cover, we have allowed for some sustainable level of experience variances in both the life embedded value and the health embedded value forecasts.

As we discuss later, we believe that Vitality's effect on mortality rates, lapse rates, and policy alterations are sustainable in the medium term. Management has indicated that it does make some small allowance for better experience in the embedded value.

In its FY 07 embedded value calculation, Discovery has made some minor modelling and assumption changes for better mortality of cR142m. We believe that this underestimates the positive effect that Vitality will have on its future mortality experience, and we are therefore comfortable about including some experience variances in our forecast of its embedded value.

Table 5: Embedded value forecast earnings summary

(Rm)	2007	2008E	2009E	2010E
EV earnings	2,440	2,687	3,197	3,787
Opening EV	10,587	12,826	15,286	18,220
Average EV	11,707	14,056	16,753	19,951
ROEV (opening EV)	23.0%	20.9%	20.9%	20.8%
ROEV (average EV)	20.8%	19.1%	19.1%	19.0%

Source: UBS estimates

The full breakdown of the return on embedded value is provided in Appendix 2.

Implied justifiable premium to EV

Our sustainable ROEV estimate can justify a premium to EV of up to 47%

Working with a cost of equity assumed to be 13%, we can crudely calculate a justifiable premium to embedded value as the ratio of this sustainable ROEV to COE. Estimating this ratio (in Table 6) we see that a justifiable premium to embedded value is 47%. This is higher than our price target-implied premium of c33%. We therefore are comfortable with our price target of R39.5.

Table 6: ROEV/COE multiple analysis

	2007	2008E	2009E	2010E
ROEV	20.8%	19.1%	19.1%	19.0%
COE	13%	13%	13%	13%
ROEV/COE	1.60	1.47	1.47	1.46
Year-end valuation implied (Rm)	20,564	22,478	26,749	31,661
# shares	591.95	591.95	591.95	591.95
Price implied (R)	34.74	37.97	45.19	53.49

Source: UBS estimates

SA life insurance rankings

Discovery Life is our top pick, followed by Liberty Group Limited

Table 7 shows the South African life insurance stocks we cover and our preferences. Discovery is our top pick in the sector, followed by Liberty, Old Mutual and then Sanlam.

We prefer Discovery for the following reasons:

- Superior prospective returns (of c78%) relative to Old Mutual (64%) and Sanlam (c48%)
- DSY trades at a deep discount to its one-year adj NAV of 0.75x (versus c0.85 for Liberty and c0.9 for Sanlam and Old Mutual), even though it has a higher ROEV.
- Strong growing life business, and stable, cash generative, dominant healthcare business.
- Imminent catalysts: (1) the potential removal of any overhang providing support for the share price; and (2) an announcement regarding the future of the Destiny business.
- The lower sensitivity to an economic downturn due to no investment product market exposure (yet) and the stable dominant healthcare membership. In the current economic environment and volatile investment markets the downside risk to earnings should therefore be lower.

Table 7: UBS coverage of SA life insurance sector

Stock	Share price	Mkt cap (US$m)	PT (R¢)	Upside	DY (+12m)	Prospective return	P/ Dec 08E adj NAV (x)	P/ Dec 09E adj NAV (x)	Rating	Rank
Old Mutual plc	132	13,700	210	59%	5%	64%	0.88	0.81	Buy	3
Old Mutual plc (South Africa)	1861	13,700	2950	58%	5%	63%	0.92	0.82	Buy	3
Sanlam Limited	1880	5,700	2700	43%	4%	47%	0.90	0.82	Buy	4
Liberty Group Limited	7360	2,800	12600	73%	6%	79%	0.83	0.75	Buy	2
Discovery	2250	2,040	3950	76%	2%	78%	0.76	0.65	Buy	1

Source: UBS estimates, I-Net Bridge Prices as of 7 February 2008

Discovery Holdings

Key advantage: Vitality. Can it be copied?

Vitality's value is spread across each business unit

We believe that Discovery's key competitive advantage is its Vitality programme. As discussed in detail in the various sections of this report, we believe Vitality is the core reason behind the exceptional profitability of the various business units within the group. We also believe it is the key advantage that will ensure that the DHMS remains competitively priced in the South African healthcare market.

The question needs to be asked: Can it be copied? We believe not.

Other providers have tried to copy the programme and have either failed or had limited success. In our opinion, Vitality succeeded and continues to succeed for these reasons:

First mover advantage was critical

- **Innovation** – Vitality was new to the South African market, and benefited significantly from the first-mover advantage. This assisted in gaining critical mass to remain viable.
- **'Opt out' rather than 'opt in'** – When Vitality was launched the default option when joining the DHMS, was to join Vitality. This way, the membership of Vitality grew quickly, making the discounts negotiations with providers easier and the business model easily viable.
- **Integration** – The ability to integrate this program across a range of financial services has increased its attractiveness to existing clients. Discovery expanding into life insurance, credit card, and now investment products, makes Vitality even more attractive as the end client now sees the Vitality premium as split across three products rather than just the medical scheme.

Those that have tried to copy it, have failed

Other financial services and medical scheme administrators have tried to replicate the Vitality model and failed. Examples include Medscheme (Liberty's medical scheme administrator), which launched its 'relode' programme in the early 2000s. Relode failed and has been discontinued. The main reason given for its failure include the lack of scale required to be able to offer competitive benefits. Sanlam launched its own loyalty programme, Reality, in 2007. As little mention of this program has been made since its launch, we remain sceptical about its success.

We believe Vitality cannot easily be copied for the following reasons:

Discounts are just not possible without critical mass

- The Vitality programme now has large-scale membership, making its negotiation power significantly larger than any start-up program, and can therefore remain competitively priced.
- The era of consumerism in the financial services industry has made it impossible to start up a programme as a default 'opt out' add on, and therefore any new scheme had suffered severe selection effects where the only members who join the program are those that will benefit to a greater extent than their premium. New programmes therefore struggle to achieve required cross-subsidies as there are very few non-engaged members.

- We believe that Discovery has some exclusivity agreements with most of the Vitality benefit providers, making it difficult for a competitor programme to offer attractive benefits.

Contracts block out the competition

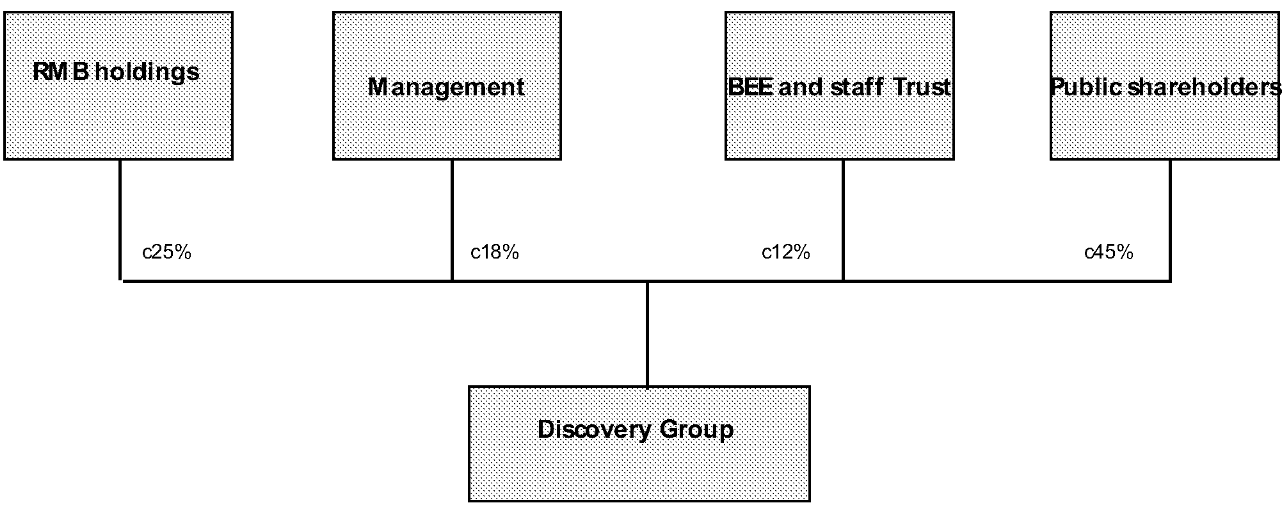
The data required to price effectively for the impact of Vitality on various assumptions in other parts of the business is immense. Having the experience of the past 10 years, Discovery is better able to understand the impact of various levels of vitality engagement on the level of claims, and the consequent discount that can be offered to a client paying life premiums. This level of understanding is impossible to replicate without the data. Essentially, any new program would need to be prepared to take on large risk that the experience might not pan out as expected, at least until credible data is obtained.

Peers cannot compete without the data, unless they take significant risk

Ownership

Figure 1 shows our estimated current shareholder split.

Figure 1: Shareholder split



Source: UBS estimates

We believe that the unbundling was done to alleviate the ongoing competition within FirstRand between Discovery and Momentum, FirstRand's other insurance group. This competition had stifled Discovery Life's growth, in our opinion, particularly because Discovery was held back by being prohibited by FirstRand to launch products that competed directly with Momentum (eg, investment products).

Unbundling removes the pressure not to compete with Momentum

We believe that the new structure creates the obvious benefits of increased liquidity and free float, but also the ability for Discovery to incentivise management to a greater degree with equity ownership. We also believe that this unbundling allows Discovery the freedom to grow further by being able to raise capital should it require it.

As part of the restructure/unbundling, CEO, Adrian Gore, invested an additional cR400m in his own capacity to take his stake in the business to c10% or cR1,5bn, demonstrating his confidence in the business.

Management takes up an additional stake; Adrian Gore invests cR400n

We do however believe that the unbundling has resulted in some 'overhang'. We believe that there are still some shareholders in FirstRand who would not want to own Discovery directly; they have become reluctant owners in the market. We believe that this is evidenced by the higher-than-expected increase in average daily trade volumes since the unbundling.

Removal of the overhang

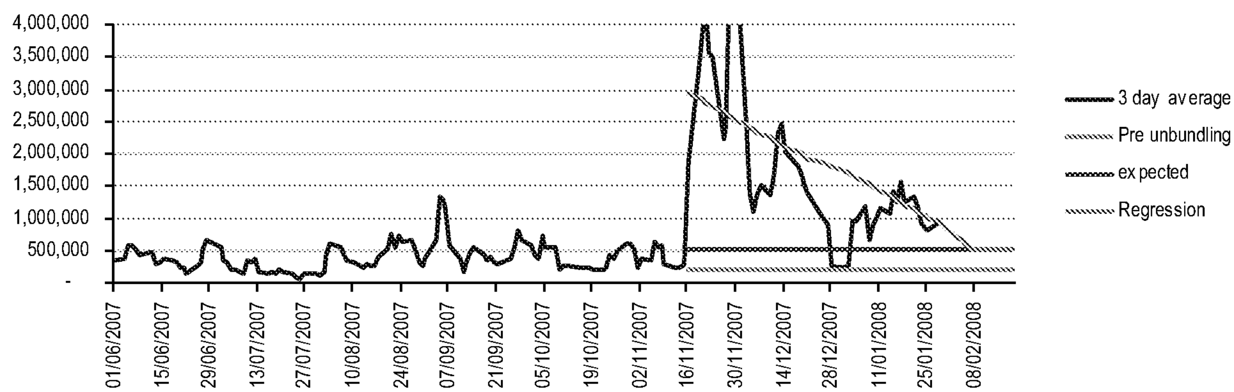
Overhang from the unbundling exits

We believe that the overhang from the unbundling of Discovery from FirstRand may be weighing on the current share price. We believe that, based on our simple linear regression analysis (Chart 3), this overhang is now almost completely out of the way.

We believe it should be eliminated by mid February 2008

We have estimated the average daily volume of Discovery shares traded on the Johannesburg stock exchange between 1 January 2000 and the unbundling 16 November 2007 at c210k. We have then assumed that this volume should increase in proportion to the increase free float post the unbundling. We have also plotted a linear regression to the average daily volume traded since the unbundling, to asses the rate at which the daily volume is decreasing. Plotting this regression against the daily trade data, we expect that the average daily volume traded should reach our expected value by the middle of February 2008 (Chart 3).

Chart 3: Volume traded on the JSE – three-day moving average



Source: UBS estimates, I-Net Bridge

Discovery Group companies

We analyse the Discovery group as the sum of its major business units being:

- Discovery Health (c22% of our SOTP)
- Discovery Life (c51%)
- Discovery Invest (c3%)
- Vitality (c2%)
- PruHealth (c4%)
- PruProtect (0%)
- Destiny Health (c-2%)

Next we describe the features of each of these business units in detail.

Discovery Health (c22% of the SOTP value)

Discovery Health is the largest medical scheme administrator in South Africa, administering the largest 'open' medical scheme in the country, the Discovery Health Medical Scheme (DHMS) (Table 8). DHMS covers some 1.9m lives (c750,000 principal members plus their dependants). Further, Discovery administers some closed schemes, bringing the total number of lives covered to c2.1m.

Discovery is by far the largest medical scheme administrator

Discovery currently administers c28% of the total lives covered by medical schemes in South Africa.

We believe that Discovery's scale provides it with a unique pricing advantage in the industry that will result in the continuous ability to undercut other schemes in the South African marketplace. The reasons for this are as follows:

Stronger negotiating power

- **Purchasing power** – we estimate that Discovery currently manages c28% of all medical scheme members in South Africa (c2m lives). The next largest scheme, BONITAS, manages c600k lives, or c10% of the industry. Discovery's ability to negotiate better tariffs with the private hospital groups is therefore significantly better than that of the other schemes in South Africa. (We estimate that Discovery fills c26% of all beds in the private hospital groups in South Africa.).

Table 8: Medical scheme membership, December 2006

Medical schemes	Average beneficiaries (2006)	Average age (2006)
DHMS	**1,823,772**	**31.1**
Bonitas medical fund	570,486	28.5
SAPOLMED	418,681	26.3
Oxygen medical scheme	222,951	32.5
Spectramed	203,168	28.5
Medihelp	197,506	44.4
Medshield Medical scheme	187,200	26.9
Bankmed	184,971	31.0
Fedhealth medical scheme	179,128	32.5
Transmed medical fund	162,117	44.7
Total Top 10 schemes	**4,149,980**	**31.2**
Total industry	**6,981,724**	**31.6**

Source: Medical schemes council

- **Better claims experience**: Vitality encourages wellness. We believe that through its wellness program, Vitality, Discovery is able to improve the risk claims experience by encouraging healthy living and preventative screening. We believe that this impacts both the incidence and severity of claims.

Better claims experience from the Vitality impact

- **Better claims experience:** Vitality lapse selection effect. Further, by virtue of the better lapse experience of members who are actively engaged in Vitality, the lapses they do experience are likely to be the high risk members, and therefore this further improves the risk experience of the remaining members in the scheme.

- **Lower average age:** As can be seen in Table 8, DHMS has an average age of 31.1, which is lower than the industry average and which should also result in lower risk experience. Again, we believe the gym membership benefit of Vitality attracts younger members to the scheme. This will however be negated once the Risk Equalisation Fund (REF) is put in place by the Council for Medical Schemes.

The impact of these effects can be seen from the lower claims ratio of c80.9% in 2006 versus the industry average of c88%, as shown in Table 9.

Table 9: Medical scheme administrator claims ratios 2006

	Average beneficiaries (2006)	% of total	Claims ratio (%)
Discovery Health (Pty) ltd	1,939,238.00	28	80.9
Medscheme Holdings (Pty) ltd	1,216,653.00	17	88.3
Metropolitan Health Group (Pty) ltd	994,415.00	14	96.8
Self-administered	766,724.00	11	90.8
Old Mutual Healthcare (Pty) ltd	357,464.00	5	90.6
Total industry	**6,981,724.00**		**88.0**

Source: Medical Schemes Council

Expect lower claims experience to continue, resulting in more competitive offering

We believe that these factors should result in the scheme having lower claims experience both in frequency and severity, ie, the net total claims cost to the scheme should be lower than at competitor schemes. This should allow the scheme to offer lower premiums (or at least lower premium increases) than its competitors. We believe that the medical schemes market is very price sensitive, and that this additional pricing power will ensure that Discovery continues to gain market share in South Africa.

Table 10 shows the average increases of some of the open medical schemes in South Africa for 2008. We can see that Discovery's increase is on the low end of the table (the third lowest) at 9.8%.

Table 10: Premium increases at SA medical schemes, 2008

Scheme name	% premium increase 2008
Bonitas Medical Fund	9.20
Medihelp	9.40
Discovery Health	**9.80**
Liberty	10.90
Spectramed	11.50
Oxygen Medical Scheme	11.90
Medshield	12
Momentum Health	13.50
Resolution Health Medical scheme	16 to 21

Source: Personal Finance

The argument is normally made that this only holds true if the scheme passes savings on to its members. This is true. One needs to take cognisance of the fact that in South Africa, a medical scheme is a not for-profit organisation. In essence, unless these savings are passed on to the members, the scheme's solvency will increase, resulting in a financially stronger scheme. That financial strength, in turn, will either give the scheme the ability to under-price other schemes, or, if at the same price, the ability to attract more members (because of its improved strength). Either way, we believe the DHMS will gain market share in the medium term.

As discussed above, the Vitality effect on lapses is to reduce claims experience because those members engaged in Vitality are less likely to lapse than those not engaged, lowering the total risk in the scheme. Over and above this, Vitality also affects the lapse rate of the scheme as a whole, improving the scheme's efficiency to Discovery. This can be seen clearly through an analysis of the experience variances within the Health businesses' embedded value over the past five years.

Regular positive experience variances come through

Looking at Table 11 we can see a regular occurrence of positive experience variances resulting from lower than expected lapse rates, mortality and policy alterations. Over the past five years, the cumulative effect of these lapse rates to the embedded value is over cR700m. On average, the positive experience variances for the three factors shown (lapses, mortality and policy alterations) is 5% of the opening VIF per year.

Table 11: Discovery Health experience variances

(Rm)	2003	2004	2005	2006	2007
Mortality	39	-	-	-	17
Lapses	86	94	200	198	120
Policy alterations	-38	24	8	6	10
Total for the three factors	87	118	208	204	147
total as a % of opening VIF	4%	4%	7%	5%	3%

Source: Company data

We calculate the average duration of the VIF is c5 (ie, the total health VIF / Expected transfer to net worth). One could crudely capitalise this experience variance and argue that the embedded value should be some c25% higher (ie, the average 5% above multiplied by the average duration).

Could argue its worth 25% more than VIF

Solvency

Much hype has surrounded the issue of solvency in the DHMS. There have been ongoing debates between Discovery and the Council for Medical Schemes regarding DHMS not being at the prescribed minimum solvency level of 25% of premiums.

Prescribed solvency penalises growing schemes

We believe that in this instance, Discovery is a victim of its own success. We believe that this solvency requirement (as prescribed in South Africa) penalises growing schemes. We can illustrate this by way of an example.

Lets assume a scheme has 100 members, paying R100,000 in gross premiums for the year, and unallocated surplus of R25 000. Its solvency is at the prescribed level of 25% (ie, surplus divided by the premiums written).

None the less, 25% should be easily attainable

Now assume the same scheme writes 100 new members on 1 January. Assuming the premiums are priced exactly to the claims experience, the scheme will still have R25,000 plus a bit of investment income at the end of the year, but the solvency level is now half of the regulated level (R25,000/R200,000 = 12.5% instead of 25%).

Solvency issue has constrained growth

In order to maintain the minimum solvency level, the scheme is required to build in 'profit' margins onto its pricing to ensure that in is left with R50,000 at the end of the year. The existing members are therefore penalised to the extent that their premiums are forced up to make these margins. For a scheme like the DHMS, which has grown rapidly over the past 10 years, this becomes a major difficulty as the increase premiums required to maintain solvency create a situation where the scheme is not longer competitive. This has therefore reduced the capacity to gain further market share in recent years.

These regulations are in place and schemes are obliged to comply with them. We expect that Discovery will attain its required minimum solvency by the agreed date (31/12/2008). We believe that this can be achieved by using the calculation as detailed in Table 12.

Table 12: Forecast DHMS solvency build up calendar year

(Rm)	2007E	2008E
DHMS		
Open reserves	3,006,863	4,252,275
Premiums for calendar	19,160,189	21,750,074
Assumed new premiums	2,541	2,590
Assumed investment return	255,583	361,443
Assumed claims ratio (81%)	(15,519,753)	(17,617,560)
Assumed admin ratio (10.5%)	(2,011,820)	(2,283,758)
Assumed managed care ratio (2%)	(383,204)	(435,001)
Closing unallocated surplus	4,252,275	5,666,030
Solvency ratio	**22.19%**	**26.05%**

Source: UBS estimates

We believe that the requirement to reach the 25% solvency level has resulted in Discovery's premium increases being greater than would otherwise be necessary in order to boost solvency in 2007 and 2008. We believe that after meeting this solvency level, Discovery will be able to moderate its premium increases and become more competitive, and still maintain its required solvency level. Again, we believe this will assist Discovery to grow its market share in the medium term.

Once the prescribed 25% is achieved, we believe Discovery can grow market share

Earnings forecast

Table 13 shows our earnings forecast for Discovery Health on an IFRS basis.

Key features are

- Low growth in FY08 as a result of the agreement to reduce administration fees for the calendar year 2007 by R3m p.m. and 1.25m p.m. in 2008.
- Sustainable growth of c10% pa on the basis of conservative member growth and the gearing to membership growth by economies of scale.

Table 13: Forecast IFRS earnings – Discovery Health

(Rm)	2007	2008E	2009E	2010E
Insurance premium income	158	169	183	200
Reinsurance premiums	(3)	(3)	-3	-4
Fee income from administration business	2,138	2,287	2,483	2,713
Investment income and gains	55	63	68	74
Net income	2,348	2,515	2,731	2,984
Insurance benefits and claims	(128)	(135)	-146	-160
Reinsurance recoveries	2	2	2	3
marketing and admin expenses	(1,432)	(1,579)	-1,724	-1,883
Tranfers from assets/liab's under insurance contracts	1	1	1	1
Expenses	(1,557)	(1,710)	-1,867	-2,039
Profit from operations	791	805	864	945

Source: UBS estimates

Valuation

We value the Discovery Health business using an adjusted appraisal value methodology consistent with other insurers we cover.

Our first step is to forecast the Discovery Health embedded value of value in-force on the Discovery basis as at each valuation point. We then adjust this value to reflect a higher risk margin of 4% (ie, the difference between the risk discount rate and risk-free rate) than the 3% used by the company in its calculation.

We use an appraisal value for the health business as the sum of...

This is consistent with our adjustments we make to other life insurers valuations as we do not believe that a risk margin less than 3% is commensurate to the risks associated with the run off of the in-force business for a company like Discovery.

...our adjusted projected VIF and...

The reason we are using 4% versus our typical range of 3% to 3.5% is that this value of in-force is concentrated around one product (the DHMS) and therefore

we feel that lack of diversification increases the uncertainty of the future profit release.

Next we value the franchise value of the health business. To do this we use a multiple of the embedded value of new business written during the year. This multiple is calculated (as with the other insurers) by assuming future growth rate assumptions and a discount rate.

... a franchise value based on a multiple of our forecast VNB

Given the maturity and market dominance of Discovery in this market, we have used a low multiple of 3x to value the franchise value of the business. We believe that this is cautious but take cognisance of the risks mentioned elsewhere in this report.

Table 14 shows our valuation of Discovery Health

Table 14: Discovery Health valuation

(Rm)	2008E	2009E	2010E
Discovery Health VIF	4,732.66	5,015.93	5,307.43
Health franchise value	197.40	195.42	199.33
Health VNB	65.80	65.14	66.44
Health multiple	3.00	3.00	3.00
Risk adjustments	(186.71)	(196.57)	(207.28)
Health VIF	(167.83)	(177.88)	(188.22)
Health franchise	(18.88)	(18.69)	(19.07)
Total Health valuation	**4,743.34**	**5,014.78**	**5,299.48**

Source: UBS estimates

As a cross check, we looked at the valuation achieved using a PE multiple of 10x on our projected IFRS earnings, as well as using a discounted cash flow model of our IFRS earnings. Both the DCF and multiple valuation methods exceed our original valuation, and we are therefore comfortable about using the valuation as detailed in Table 14.

Valuation more conservative than a 10x P/E or DCF valuation

Discovery Life (c51% of the SOTP)

We believe that Discovery Life is the only significant start-up life company in South Africa in the past 10 years. The South African life insurance industry has historically been dominated by the larger players, providing barriers to entry for new entrants.

Success in a market dominated by incumbents

We believe that Discovery Life has been successful in starting up this life division for the following reasons:

- **Vitality:** As with the health business, we believe that Vitality offers the life business some key selection advantages resulting in higher margins, and positive experience variances than would be the case without Vitality; this is discussed in more detail below.

Again, Vitality is key to its success

- **Product innovation:** Discovery Life was first to the market with a pure risk-based product (i.e. without the attached investment product of traditional SA insurers). This allowed it to effectively make the market in this product range, and gain first-mover advantage. This was particularly successful as the

Product innovation becoming synonymous with Discovery

market had become increasingly sceptical about the relative costs associated with life insurance investment products to pure unit trust savings products, and hence attracted policyholders (and brokers) as it allowed them to retain the life cover without paying these perceived high costs.

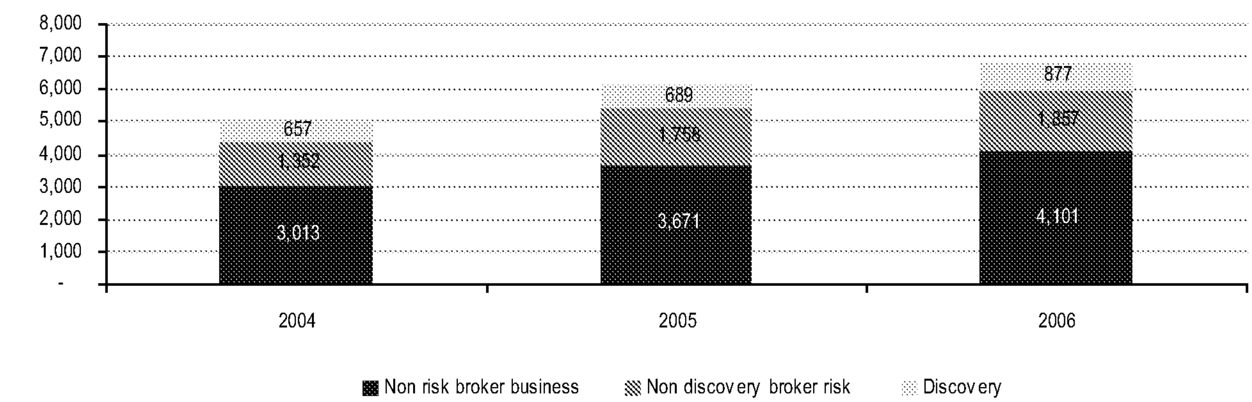
No legacy products, no bad publicity

- **Lack of "legacy" retirement annuity products:** In 2005 when insurers agreed to limit the surrender penalties charged to policyholders, the life insurance industry was in turmoil and sales suffered as a consequence. Discovery, however, was not plagued by these legacy products as all it sold were pure risk products. This allowed it to gain market share away from the other players who were continually being named in the media as being penalised by the pension fund adjudicator rulings at the time. The lack of poor publicity around the Discovery brand at the time made it an easy sell for an IFA.

Largest writer of broker sales

These have resulted in Discovery rapidly becoming the largest new business writer of risk business among the IFA marketing South Africa writing some c32% of broker "Risk" new business API (c13% of total broker business in the calendar year 2006 (see Chart 4)). Risk broker business constitutes c10% of total retail life insurance business in South Africa.

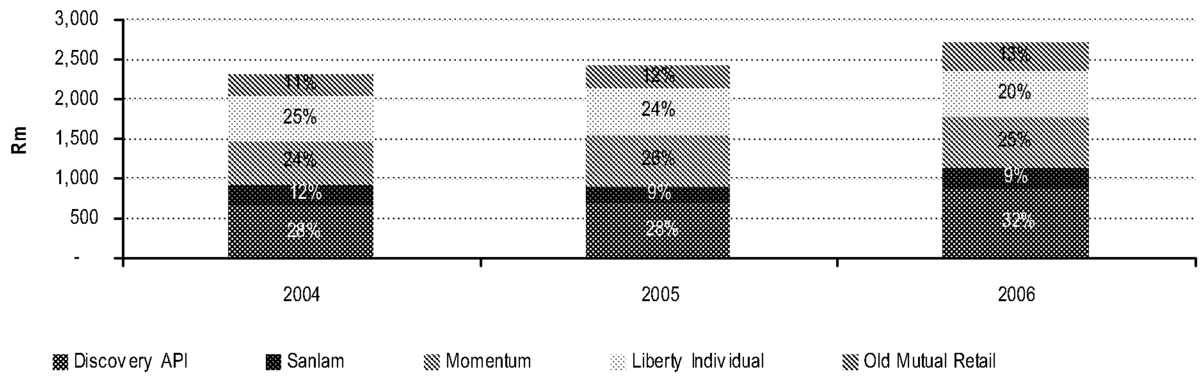
Chart 4: SA broker market share estimates



Source: UBS estimates, Life Offices' Association

We have estimated the broker "risk" new business of five of South Africa's largest insurers to assess who has lost this market share that Discovery has gained. Unfortunately, the data is not publicly disclosed, so estimates have been used. From Chart 5 we can see that it appears that Liberty has been the major market share loser in this period amongst broker risk business. This makes sense as Liberty is based in Gauteng, which is Discovery's home region.

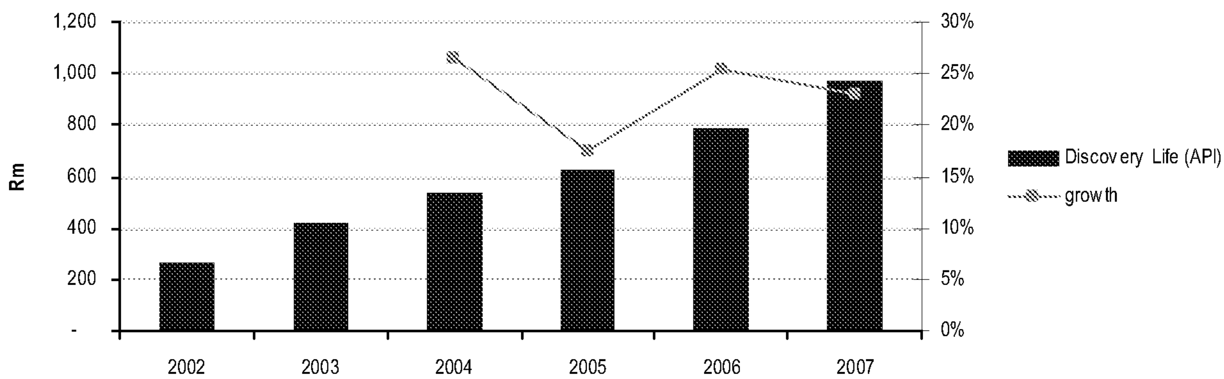
Chart 5: Broker risk market share estimates



Source: UBS estimates, company data

The strong growth in market share with the brokers has resulted in new business sales having grown between 18% and 25% over the past four financial years. (See Chart 6)

Chart 6: Financial year API growth rates

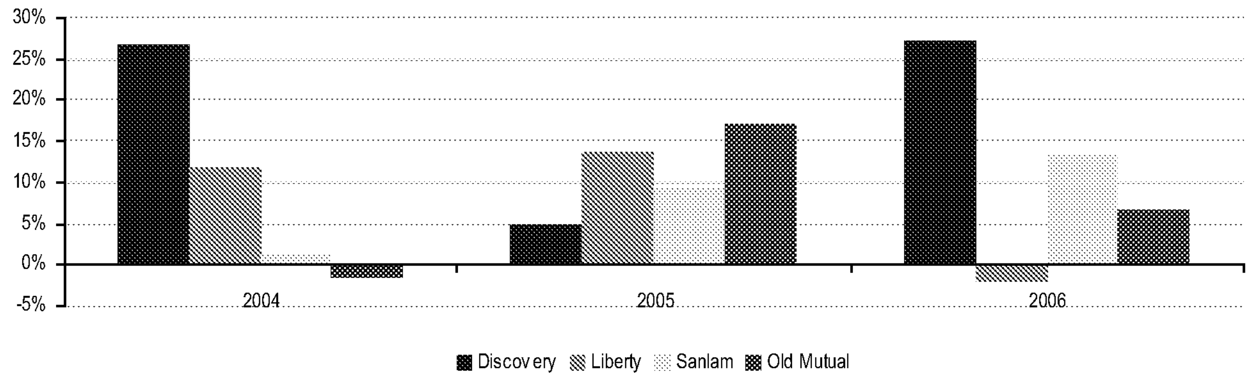


Source: Company data

Growth not seen by the other insurers we cover

This is in stark contrast to the growth in APE seen by the other major insurers and, in fact, the industry as a whole. As Discovery's financial year does not coincide with that of the other insurers, we have adjusted the next chart to represent calendar year volumes for easier comparisons. Chart 7 illustrates the calendar year growth rates in new business APE.

Chart 7: Calendar year API growth rates



Source: UBS estimates, company data

We believe that these levels of growth in new business will taper off now that Discovery has a significant share of the broker market. (In fact, Discovery is currently writing the largest portion of broker risk business).

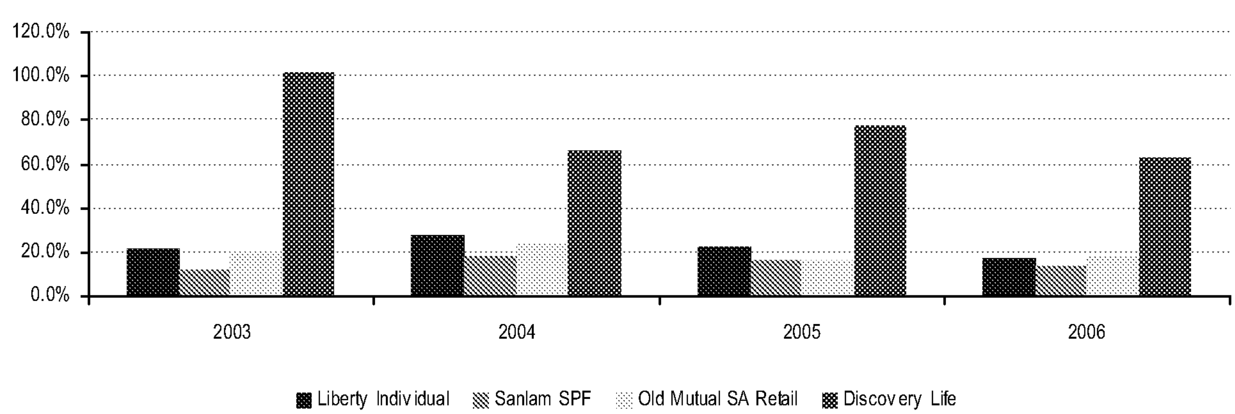
New agency force should help maintain impressive sales growth

Discovery has however launched a tied agency force in early 2007. We believe that Discovery has recruited only experienced, large-volume writers to its agency force, as is demonstrated by the fact that by August 2007, the agency channel was writing c8% of total new business volumes, despite only having c130 agents on board. We expect that this channel will help Discovery continue to maintain growth in excess of other players in the short to medium term.

Margins not strictly comparable, but exceptional none the less

Further, this exceptional growth has arisen along with exceptional margins. Chart 8 details the margins relative to the other insurers we cover. Importantly, these comparisons are not like for like, as the other insurers have vastly different business mixes and do not publish their margins for their risk business similar to that of Discovery.

Chart 8: SA comparative retail margins



Source: UBS estimates, company data

Discovery's APE (and PVNBP) margins are exceptionally high for the following reasons:

- Better mortality – Discovery has, through its Vitality wellness programme, managed to attract and retain a better risk pool from a mortality point of view. Intuitively this makes sense. By offering large discounts on wellness-related activities, e.g. gym membership, Discovery attracts more health-conscious people, who are therefore on average lower risk lives.

- Better remaining policyholders from lapse experience – again due to the Vitality programme, those that are engaged in the programme (i.e. actively go to gym) are less likely to lapse. As those that don't lapse, Discovery is left with an improved pool of lives with better mortality experience of the remaining policyholders. This is enhanced by the impact of the life integrator.

- Business mix –The mix of business has always been the "higher margin" pure risk products, and no lower-margin investment products.

- Ancillary products – These products, which are sold alongside a Discovery Life plan, have significantly higher margins through lack of competitive pressure. Once a client decides to buy a Discovery product, he/she has already done the market comparisons to assess value for money. When it comes to buying the ancillary products, the client and broker are unlikely to get competitive quotes for the small add-on type protection. Further, these ancillary products are generally niche products, and difficult to compare with other insurer's products. As such, there are very few competitive forces keeping premiums in this area low and Discovery is therefore able to make significantly higher profit margins on these products.

- Higher-income target market – the average premium at Discovery is R850 p.m. (see Table 15). This is more than double the industry average of cR350, highlighting its higher-income target market. With higher premiums, the margin tends to increase as the fixed costs can be written against a higher average premium, resulting in an increased margin per rand of premium.

Target market has the highest average premium

Table 15: Average monthly premium

	Latest provided
Discovery	**850**
Industry average premium size	**350**
Liberty Individual business (ex "@ work")	764
Old Mutual affluent market	350
Sanlam SPF	500
Liberty @ work	150
Old Mutual mass market	208

Source: UBS estimates, company data

Management is confident that it can maintain the currently high levels of margins, but we believe they are not sustainable. In our view, to continue to grow new business Discovery will have to reduce its margins over time. Competitor products will also be developed to compete more directly with Discovery, putting price pressure on Discovery products.

Furthermore, with the launch of Discovery Invest, the company has now entered the lower-margin investment product market. As this starts to make up more and more of the mix of products sold, we would expect the Discovery Life margins to compress naturally.

While we expect margins to decrease, we still expect them to remain high relative to the other insurers. In Table 16 we illustrate our forecast APE margins for the four insurers we cover:

Table 16: UBS APE margin forecast for SA insurers

	FY07E	FY08E
Liberty	16.2%	16.2%
Old Mutual SA	16.0%	16.0%
Sanlam	16.9%	17.2%
Discovery (actual for FY07)	63.0%	50.0%

Source: UBS estimates

The Vitality impact on mortality can be demonstrated by analysing the experience variances in the embedded value statements for the past five years (see Table 17). We can see that on average, the mortality experience variances have been cR56m pa or c12% (c6% if you exclude 2003) of the opening Discovery Life VIF. On a cumulative basis, this has added cR534m to the embedded value over the past five years.

Table 17: Discovery Life experience variance history

Life experience variances	2003	2004	2005	2006	2007
Mortality	22	26	68	81	85
Lapses	9	-53	-8	-56	-23
Alterations	53	100	71	52	107
Total for the three factors	84	73	131	77	169
total as a % of opening VIF	30%	10%	12%	4%	4%

Source: Company data

The policy alterations referred to above largely relate to policyholders taking out additional ancillary products alongside an existing policy, which are highly profitable, as explained above.

Life VIF up to 36% undervalued

As we have shown with the health business, we could crudely capitalise these variances by looking at the duration of the value of in-force (i.e. VIF/expected transfers to net worth) of c9. We would therefore argue that the value of in force is understated by c36% (9 x 4%).

Earnings forecast

We forecast Discovery Life's earnings on both an embedded value and IFRS basis but do not include the Discovery Invest business, which we cover separately. In Table 18 we detail our IFRS forecast. The key feature of the forecast is the reduced investment income and gains impact on the operating profit than that achieved in FY07.

Table 18: Discovery Life IFRS earnings forecast [Rm]

	2007	2008E	2009E	2010E
Insurance premium income	2,353	3,011	3,726	4,463
Reinsurance premiums	-500	-640	-792	-948
Fee income from administration business	4	5	6	8
Investment income and gains	434	234	288	359
Net income	2,291	2,610	3,229	3,881
Insurance benefits and claims	-877	-1,176	-1,514	-1,883
Reinsurance recoveries	393	512	633	759
Acquisition costs	-888	-1,066	-1,172	-1,289
Marketing and admin expenses	-404	-517	-640	-766
Trfs from assets/liabs under ins contracts	626	751	826	909
Fair value adj to liabs under inv contracts	-141	-76	-94	-117
Expenses	-1,291	-1,571	-1,960	-2,388
Profit from operations (pre tax)	1,000	1,039	1,269	1,493

Source: UBS estimates

Our embedded value earnings forecast is detailed in the embedded value section above.

Valuation

Valued as an appraisal value as for other insurers except...

We value the Discovery Life business using an adjusted appraisal value methodology consistent with that used for the other life insurers we cover. Note that this valuation excludes the valuation of Discovery Invest, which we cover separately.

Our first step is to forecast the Discovery Life embedded value of in-force on the Discovery basis as at each valuation point. We then adjust this value to reflect a risk margin of 4% (i.e. the difference between the risk discount rate and risk-free rate), which is higher than the 3% used by the company in its calculation.

This is consistent with the adjustments we make to other life insurers' valuations as we do not believe that a risk margin of less than 3% is commensurate with the risks associated with the run-off of the in-force business for a company like Discovery.

The reason we are using 4% vs. our typical range of 3% to 3.5% is that this value of in-force is concentrated around one product range and therefore we feel that lack of diversification increases the uncertainty of the future profit release.

Next, we value the franchise value of the life business. To do this, we use a multiple of the embedded value of new business written during the year. This multiple is calculated (as with the other insurers) by assuming future growth rate assumptions and a discount rate.

...a more detailed approach required to franchise value due to infancy

Given the infancy of the business relative to the other long-established insurers we cover, we have taken a cautious view on the franchise value. Our discount rate adopted is 17%. This equates to a risk margin of 8%, i.e. double that for the value of in-force, to reflect the uncertainty of actually selling the projected levels of new business.

Usually, for a mature life business, our new business multiple is an annuity factor derived by the risk discount rate and a long-term growth rate. In this case, however, the business is still growing rapidly and we believe an annuity multiple would be too simplistic.

Our detailed new business multiple calculation is show in Table 19. We have estimated growth rates in new business sales to 2013. We have factored in high growth for FY08E and FY09E of 15% and 13% respectively, tapering off for the impact of adding the agency force distribution channel in FY08.

We have also cautiously allowed for a sharp reduction in new business margins to 30% from FY12E (from the c63% currently experienced). Lastly, we have used a perpetuity multiple to value the new business flow from 2013 onwards – a point at which we believe the business will be in a more stable mature state. Discounting these factors back at our 17% discount rate gives us a multiple of 7.66x.

Table 19: Discovery Life new business multiple calculation

Discount rate		**17%**					
New business multiple		**6.10**					
	Base VNB	**Sales Growth rate**	**Base X growth**	**Base APE Margins**	**Est NB margin**	**Projected VNB**	**PV**
FY08E	1	15%	1.15	65%	63%	1.13	0.96
FY09E	1	13%	1.30	65%	45%	0.90	0.66
FY10E	1	11%	1.44	65%	40%	0.89	0.56
FY11E	1	10%	1.59	65%	35%	0.86	0.46
FY12E	1	9%	1.73	65%	30%	0.80	0.37
FY13E	1	7%	1.85	65%	30%	0.86	0.33
Beyond		6%	1.96	65%	30%	0.91	2.76
							6.10

Source: UBS estimates

Table 20 details our valuation for the life business excluding the Discovery Invest business valued separately, and the capital backing the business which is valued in our "balanced portfolio".

Table 20: Discovery Life valuation (excl balanced portfolio)

	2008E	**2009E**	**2010E**
Discovery Life VIF	7,467.01	9,315.20	11,393.05
Life Franchise value	4,509.12	4,960.03	5,456.04
Life VNB	739.20	813.12	894.43
Life Multiple	6.10	6.10	6.10
Risk Adjustments	-1,168.00	-1,357.08	-1,568.00
Life VIF	-489.94	-611.21	-747.54
Life Franchise	-678.06	-745.87	-820.46
Total Life Valuation	10,808.13	12,918.16	15,281.08

Source: UBS estimates

Discovery Invest (c3% of the SOTP)

In October 2007, Discovery launched its long-anticipated investment product business, Discovery Invest.

We believe that this business has been launched for two reasons:

- **Product co-sale:** We believe that in the South African broker market, brokers and clients prefer to deal with a single provider for all their personal finance needs. This assists the broker from an administration point of view but requires the product provider (in this case Discovery) to become a "one-stop shop" in order to sell any products. We believe that the lack of preservation fund products and endowment wrapped savings products is one of the reasons for the poor sales of the Discovery Retirement Optimiser product launched in 2005.

Need to create a one-stop shop

- **Profitable market:** In order to broaden its product range and capture more of the client's "wallet". The Linked Investment Service Provider (LISP) market size by assets is in excess of R250bn. Using its brand and existing client base to attract a portion of this could well result in material profits for Discovery in the future.

There is money to be made in LISP business

We believe that the Discovery Invest product range will be less successful that the company hopes. Our reasons for this are:

- **Product complexity:** In an age of increased consumerism in the South African retail investment market, we believe that the complex nature of the product range will deter potential investors. We believe that while some of the features would be attractive (the fee integrator etc), they may be too complex to be fully understood by the client and, possible, even by the advisor.

Product may be too complex for the investment arena

- **Product Pricing:** We believe that the Discovery Invest products are priced at the upper end of fees charged by their peers (see Table 21). While the fee scales don't appear high, the additional "VAT expense" does raise these fees above many peers' fees. According to the marketing material provided to advisors, the administration fees and initial fees on the endowment, annuity and preservation fund wrappers are quoted as their sliding fee scale "plus VAT". We believe these fees constitute "exempt supplies" and that VAT should therefore not be charged. Management has confirmed that the fee scale is "increased by 14% to offset VAT expenses". Given that Discovery Invest aims to charge a "transparent, simple and competitive fee scale", and the current age of investment fee transparency we think this may contradict its aim, and may deter advisors from recommending that clients invest in these products.

Fees are on the high side, especially when you add the additional "VAT"

Product range

Discovery Invest's product range is similar to those offered by most Linked Investment Service Product companies (LISPs) in South Africa. The range consists of product wrappers such as endowments, preservations funds, retirement annuities and linked or fixed annuities. These products are well commoditised in the South African retail investment space, largely as a result of the regulatory environment.

The products then offer a range of investment portfolios in which to invest. This is where Discovery has attempted to differentiate itself from the rest of the LISPs in the market through innovative funds. These include:

- A wide range of unit trusts, as are available at other LISPs.
- A new range of Discovery-branded unit trusts, managed by Investec Asset Management.
- A range of multi-manager funds, managed by Investment Solutions, the largest multi-manager in South Africa.
- A range of "target retirement date" funds in which the asset allocation is adjusted on a life-stage type approach to a specified target retirement date. We believe this is a unique concept in South Africa.
- A range of "rightchoice" investments which are designed to give the investor a portion of the outperformance of a selection of unit trusts, should they beat the investors chosen fund. Again, we believe this is unique in the SA LISP market.
- A range of structured funds developed by Deutsche Bank, including a fund that dynamically alters asset allocation as market conditions change, as well a CROCI and SOLAR fund, which are designed to utilise Deutsche Bank's research to determine which stocks to invest in.

Whilst the product innovation in some of these investment funds is welcome in the South African market, these funds are more expensive than the similar peer funds (where available) and hence we are sceptical about the attractiveness of these investments to retail clients, particularly those with the better advisors.

Product wrapper fees

Wrapper fees not exorbitant, but not cheap either, "VAT issue" may create a negative impression

As we have said, the wrappers that are being used are highly commoditised in South Africa, and are therefore likely to be largely differentiated by the fees being charged for the administration of the wrapper. We believe that Discovery Invest's wrapper fees are likely to deter investors as they are higher than those charged by the range of LISPs detailed in Table 21 and Table 22. We expect that the "VAT issue" discussed previously will impact their attractiveness.

Surprised to see initial fees being charged

In the tables we have compared both the initial fees and ongoing fees charged by the various LISPs on their quoted fee scales. These initial fees are often not charged by the other LISPs, and in fact are not even mentioned by the newer LISPs in the market (see Allan Gray and Coronation). We were therefore surprised to see high initial fees being charged by Discovery (plus VAT), which we believe may deter clients. Allan Gray does not even charge an ongoing administration fee.

Their initial fees are, however, favourably comparable to those of Stanlib but higher than Momentum's. We believe these will be Discovery's main competitors given their geographical dominance in Gauteng, Discovery's home region.

Discovery's annual fees, however, are one of the most expensive in the market.

Table 21: Endowment product initial fee comparison

Initial fees in the ball park, but on the upper end

Investment lump sum (R)	250,000	500,000	1,000,000
Discovery	4,070	6,470	-
Momentum	3,125	5,625	8,750
Coronation	-	-	-
Allan Gray	-	-	-
Stanlib	4,138	6,560	9,125
Old Mutual Investment Frontiers	6,250	9,375	-
Sanlam Glacier	4,469	7,022	7,022
Investec FundSelect	3,420	5,558	8,408
Regular premium investment amt	**5,000**	**7,500**	**10,000**
Discovery	109	147	173
Momentum	113	163	213
Coronation	-	-	-
Allan Gray	-	-	-
Stanlib	100	150	200
Old Mutual Investment Frontiers	125	188	250
Sanlam Glacier	112	168	223
Investec FundSelect	86	128	171

Source: Company data, UBS estimates

Table 22: Annual administration fees

Annual admin fees second highest

Fund value (R)	250,000	500,000	1,000,000
Discovery	2,138	4,006	6,999
Momentum	1,500	2,750	4,500
Coronation	2,850	5,700	11,400
Allan Gray	-	-	-
Stanlib	2,138	3,563	6,413
Old Mutual Investment Frontiers	1,500	3,000	6,500
Sanlam Glacier	2,655	3,580	5,955

Source: Company data, UBS estimates

Fund charges

Fund charges are expensive, particularly for their innovative funds

While the above administration charges are not out of line with some players in the industry, we believe that Discovery's fund charges are the area where it are excessively expensive.

The core philosophy of the company is expressed as one of product innovation and to this end the marketing of Discovery Invest has been heavily geared toward their "rightchoice" funds.

On the face of it, these funds appear immensely attractive. The product allows you to invest in your choice of unit trust fund, and, should your chosen fund underperform some other specified funds, your investment is "boosted" by up to

100% of the underperformance. In essence, it is advertised as giving the client the benefit of hindsight in order to ensure you choose the best-performing investment.

An analysis of the detail, however, shows how expensive these funds are in reality. Investors are charged a "structuring fee" of 0.25% upfront and 0.75%pa (again plus VAT) over and above the fund management fee charged within the chosen fund. Further, the investor does not receive any dividends earned in their chosen fund. The dividend yield on the FTSE/JSE All-Share Index is currently c3% pa. One can therefore incorporate an additional "fee" of c3% in the comparisons.

The effective fee being charged is therefore close to 4% pa over and above the investor's chosen investment management fee. i.e. only if the chosen fund underperforms by 4% pa over a five- year period does the client benefit from this product.

We believe that the marketing message, however, is strong and the product will sell well initially. But in the longer term, we expect clients and advisors will come to realise the costs and therefore be deterred from these funds in future.

Other areas where we believe Discovery is excessively priced are as follows:

- Most of the investment funds charge a 0.25% initial investment fee. The South African investment market has largely done away with these initial fees. We believe that Discovery will need to remove these fees in the near term, bowing to broker pressure to do so.
- The structured portfolios also charge structuring fees over and above the standard investment fees of up to 1% pa (plus VAT).
- The target retirement funds are also expensive. These funds charge a fee of 1.5%pa. This fee is in line with those charged for equity or balanced funds in South Africa. The nature of the product is to switch between asset classes towards bonds and cash as a client nears his retirement date. These fees, however, remain at these levels even when the fund's investments are mostly fixed interest and cash assets. Similar bond/cash funds would only be charging c0.6% to 0.8% pa.

The targeted retirement date funds charge equity-like fees even when the portfolio is mostly bonds and cash

Potential asset size

We believe fees will hamper fund flows

We believe that Discovery may struggle to lure clients away from competitors due to the fund charges within the portfolios. We do, however, believe that Discovery will attract clients who are already life plan clients due to the reduced fees on the investment integrator, which will have the effect of reducing the above fees (and the investment management fees should the client choose a Discovery Invest fund) by between 40% and 100%.

Furthermore, we believe Discovery will be more successful at attracting the assets of those clients who are on the higher Vitality status and therefore stand to gain most from the fee reduction.

Expect first successes to be the endowment product with the fee integrator

In our view, the entry point for these clients will be the endowment products, for which the discount holds, and the flow of funds into the other products will largely come from the same clients due to the market preference for a one-stop shop approach to financial providers.

Looking at the Q4 2007 unit trust data in Table 23, we can get a sense of the take-up of the fund management business to the end of 2007. The product launch occurred in October so there has been very limited sales time to gain assets to this date.

Initial indications show no immediate uptake

Table 23: Unit trust funds under management

(Rm)	Fund	Market value
31/12/2008	DISCOVERY 2010 FUND	9.55
31/12/2008	DISCOVERY 2015 FUND	9.34
31/12/2008	DISCOVERY 2020 FUND	8.92
31/12/2008	DISCOVERY 2025 FUND	8.91
31/12/2008	DISCOVERY 2030 FUND	8.85
31/12/2008	DISCOVERY 2035 FUND	8.85
31/12/2008	DISCOVERY 2040 FUND	8.77
31/12/2008	DISCOVERY ABSOLUTE RETURN FUND	10.24
31/12/2008	DISCOVERY BALANCED FUND	17.40
31/12/2008	DISCOVERY DIVERSIFIED INCOME FUND	11.46
31/12/2008	DISCOVERY EQUITY FUND	22.96
31/12/2008	DISCOVERY FLEXIBLE PROPERTY FUND	14.20
31/12/2008	DISCOVERY GLOBAL BALANCED FUND OF FUNDS	9.01
31/12/2008	DISCOVERY GLOBAL EQUITY FEEDER FUND	11.15
31/12/2008	DISCOVERY MONEY MARKET FUND	34.37
31/12/2008	**Total**	**193.98**

Source: Association of Collective Investments

Given that the funds were started with R8m seed capital each, we can see that very few of the funds have attracted any flows whatsoever. The targeted retirement date funds have attracted no inflows.

Discovery brand will provide some lure, in our opinion.

We cannot, however, ignore the strength of the Discovery brand. As mentioned elsewhere in this report, Discovery is one of the most successful brands to start up in South Africa, if not the most successful new brand, of the past 20 years.

We therefore believe that Discovery Invest could grow to cR10bn in three years, which is c4% of the total assets in the LISP industry as at end-September 2007 of cR250bn. Table 24 shows our FUM forecasts for Discovery Invest.

Table 24: FUM forecast for Discovery Invest

	2008E	2009E	2010E	2011E	2012E
Total closing FUM (Rm)	1,030	3,224	5,703	8,504	11,670

Source: UBS estimates

Margins

We expect that during the first five years, Discovery Invest's product breakdown will be more skewed to the endowment products than the rest of the industry and as a result of the fee reductions. We therefore expect Discovery Invest's margins will be below those seen elsewhere for the following reasons:

Expect low margins due to...

- **Investment Integrator:** We expect that (initially at least) the new business is likely to come from existing Vitality members who are eligible for large discounts on their fees. We therefore expect the revenue to be below that of an average LISP.

...integrator impact and...

- **Asset management cost:** We believe that by not starting up its own fund manager, and by using Investec to manage Discovery-branded funds, has resulted in an increased cost to Discovery and therefore margin pressure.

...3rd party fund manager

Earnings forecast

Given our low estimate of the FUM growth and the high proportion of assets we believe will attract discounts, we do not expect that Discovery Invest will become a material revenue generator within the Discovery stable. We view this business as more of a value-add to existing clients and a further value proposition enhancement to those existing Discovery clients similar to Vitality, and expect that the benefits to the group will also emerge from lapse rates among Discovery Invest clients.

Table 25 details our earnings forecast for this business unit.

Table 25: Discovery Invest earnings forecast

	2008E	2009E	2010E	2011E	2012E
Insurance premium income	1,000	2,000	2,000	2,000	2,000
Fee income from administration business	17	48	78	112	151
Investment income and gains	130	394	679	1,001	1,336
Net income	1,147	2,442	2,757	3,114	3,517
Insurance benefits and claims	-100	-200	-200	-200	-200
marketing and admin expenses	-11	-13	-17	-18	-23
Trfs from Assets/Liabs under ins contracts	-1,030	-2,194	-2,479	-2,801	-3,166
Expenses	-1,141	-2,407	-2,696	-3,019	-3,389
Profit from operations	5	35	61	95	127

Source: UBS estimates

We value the business by forecasting our earnings to 2012, and applying a discounted cash flow model to the earnings. Our discount rate is 17% and our long term (terminal) growth rate is 5%. We then apply a tax rate of 30% to the business.

Table 26 summarises our valuation for the business.

Table 26: Discovery Invest valuation

RDR	17.0%							
Terminal growth rate	5.0%							
PV of profits at	**Post tax total**	**Pre tax total**	**2008E**	**2009E**	**2010E**	**2011E**	**2012E**	**Terminal value**
30/06/2008	543	776	5	30	45	59	68	569

Source: UBS estimates

Discovery Vitality (c2% of the SOTP)

Vitality is core to the success of the rest of the business

We believe that Discovery Vitality is the core reason behind the success of the Discovery group. Vitality was a concept new to the South African health and life insurance industry when it started, with many players looking on with some scepticism while Discovery slowly but surely built a successful franchise.

Management has described Vitality as a wealth management business unit. Its purpose is not to generate large profits. In fact, management has been quoted as saying that Vitality is a cost centre that makes a small profit.

Covers its own costs

In essence, Vitality makes some R30m to R50m pa in operating profits. This is not negligible, but it is also not significant in the greater scheme of the group.

What it brings to the other parts of the group, however, is very significant. We believe one can credit Vitality for a large portion of Discovery Life's exceptional margins. So too the experience variances being seen on both the life and health embedded values. Further, the Vitality brand is a primary reason for the attractiveness of the Discovery brand to non-Discovery clients.

Vitality is the core wellness programme that integrates into all of Discovery's businesses in one way or another. Its revenues are generated by premiums paid by members on a monthly basis, dependent on the number of dependants on the medical scheme as per Table 27. Vitality then proceeds to negotiate discounts with various providers to assist members being able to benefit from the scale of the Vitality membership.

Table 27: Vitality membership premiums

	Vitality	Vitality and KeyClub
Main member	R92pm	R94pm
Main member + spouse or 1 dependant	R108pm	R112pm
Main member + 2 or more dependants	R112pm	R122pm

Source: Company data

Success linked to attractive partners who have exclusivity contracts

Currently c60% of the Discovery Health membership are members of Vitality, with the core benefits used being the gym memberships through Virgin Active and Planet Fitness (the country's two largest health club chains); the Ster-Kinekor benefits (the country's largest cinema group); and the kulula.com benefits (the country's largest budget airline).

Discovery shares the cost of the benefit provided to its members with the partner.

Discovery took this concept a step further by launching the Discovery credit card. Here, the member gets discounts on shopping at partner stores. Again the costs of these discounts are shared with partner stores.

Cost of all benefits are shared with the provider to some degree

The Vitality programme is very popular among members (given the fact that c60% of members have opted for the product at the additional cost to their healthcare) and this benefits Discovery in the following ways:

- The Vitality benefit reduces lapses in the health scheme, resulting in high positive experience variances and despite lower lapse assumptions than many competitors. Vitality members who actively use the benefits do not want to lose the savings and therefore are less likely to lapse. Improved lapse experience is very profitable for a life business as it can cost up to six times as much to acquire a new policyholder in terms of acquisition costs than it does to maintain an existing policyholder.

Improves lapse experience on the health scheme

- The Vitality programme results in a better risk experience. The most popular benefit of Vitality is the gym membership. Given that increasing physical activity improves mortality statistics and illness frequency and severity, the Vitality members who use these benefits have lower risk costs than the rest of the market and therefore improve the profitability in Discovery Life.

Selection results in better pool of risks

- The "integrator benefits" brought about by being a Vitality member across the Discovery businesses results in an easy co-sale of products to clients that perhaps have a life policy but are not yet members of the medical aid etc. This improves new business potential across the group.

Integrator lends itself to a one-stop-shop sale

Earnings forecast

We believe that Vitality is run on a smoothed profitability basis. We expect that Vitality will be priced to achieve smooth premiums, and a smooth, small profit to the group. The ultimate aim is to cover its own costs.

We therefore believe that Vitality's premium income growth potential is limited to the extent that the membership of the medical scheme grows and the new business policyholder growth in Discovery Life.

Our earnings forecast for Discovery Vitality is shown in Table 28:

Table 28: Vitality forecast earnings

Income statement	2005	2006	2007	2008E	2009E	2010E
Investment income and gains	8	10	15	16	17	18
Vitality income	521	654	721	760	802	844
Net income	529	664	736	776	818	862
Acquisition costs	-55	-66	-51	-56	-60	-62
Marketing and admin expenses	-429	-547	-627	-661	-697	-734
Expenses	-484	-613	-678	-717	-757	-796
Pre-tax profit from operations	45	51	58	59	61	66

Source: UBS estimates

Vitality valuation

We value Vitality on a discounted cash flow model as shown in Table 29. Our assumptions for the valuation are also shown in the table for reference.

Table 29: Vitality valuation

Assumptions							
RDR	**13%**						
Terminal growth rate	**3%**						
PV of profits at	**Pre tax total**	**Post tax total**	**2008E**	**2009E**	**2010E**	**2011E**	**2012E**
30/06/2008	**699**	**489**	**59**	**54**	**51**	**48**	**44**
30/06/2009	**723**	**506**	**-**	**61**	**58**	**54**	**50**
30/06/2010	**748**	**524**	**-**	**-**	**66**	**61**	**57**

Source: UBS estimates

PruHealth (c4% of the SOTP)

Vitality in demand from foreign players

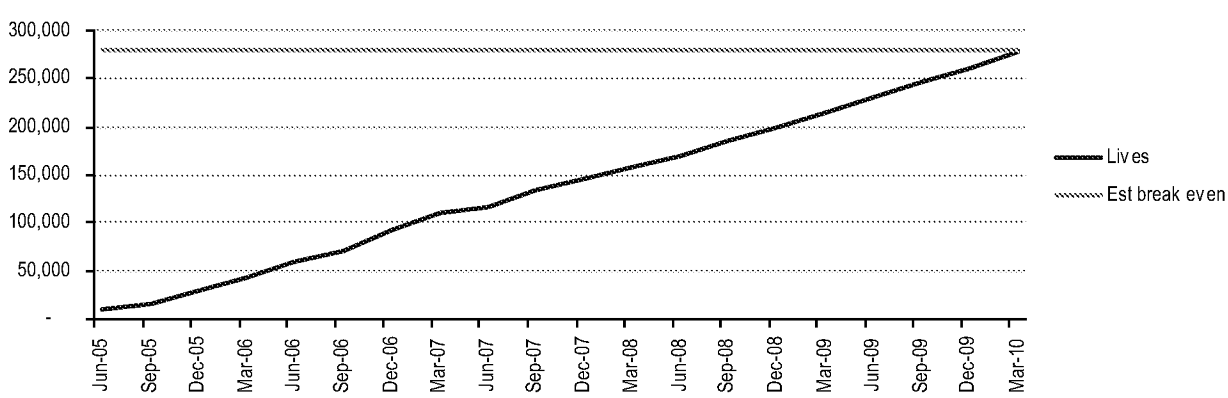
PruHealth was started in 2004 as a 50/50 JV with Prudential in the UK. Importantly, Prudential approached Discovery to start this business with its Vitality technology. We believe that this is further evidence of the strength of the Vitality concept, and the difficulty with which it would be replicated.

The structure has now changed with the new 50/50 JV called PruProtection within which PruHealth and PruProtect (discussed later) sit.

Membership growth strong, c142k members at 31 Dec 07

The membership growth in PruHealth had been strong with c142k lives under cover as at the end of December 2007 (See Chart 9). The chart also shows the level at which we expect this business to break even. Management believes it will start breaking even by the end of 2008. We are more cautious, and expect that its first full breakeven financial year will be FY10, with its monthly breakeven starting in late 2009.

Chart 9: PruHealth estimated membership projection



Source: UBS estimates

Expect the same impact of Vitality on its experience in the UK

Following the South African model, we believe that PruHealth will be able to benefit from strong selection effects by members who want to use the Vitality gym benefits. The cost saving for an active gym user (i.e. more than twice a week on average) can range between £25 p.m. and £50 p.m. The corresponding

cost of the PruHealth comprehensive policy for an adult in their early 30s is c£50 p.m. The incentive is therefore clearly there for an active gym user, who wants health cover, to join PruHealth rather than other providers.

This is particularly true for people using the gyms in central London, where the standard gym rates (and therefore savings) would be on the upper end of the scale.

We therefore expect that the selection effects will result in PruHealth attracting younger and healthier policyholders, resulting in improved risk experience, and therefore better profitability.

Mandatory Vitality will assist in success, possible separation later

Because Vitality is mandatory within PruHealth, it will ensure that this selection effect comes through from the outset, in our view. We would expect that at a later stage, once a level of critical mass is achieved, PruHealth may offer a product excluding Vitality and move into the more traditional health insurance product space.

Different approach to entering the market

We believe that PruHealth will be successful as it has taken a different approach to other start up health insurers. Instead of offering cheaper premiums by removing certain claimable benefits (that others have done), it is providing cheaper premiums to those that take an active interest in improving their health, and therefore, expected claims experience.

Earnings forecast

Table 30 details our earnings forecast on an IFRS basis for the PruHealth business. Note that this is Discovery's (50%) share of all earnings, revenue and costs.

Table 30: PruHealth IFRS earnings forecast

(Rm)	2007	2008E	2009E	2010E
Insurance premium income	278	486	742	1,081
Reinsurance premiums	-25	-44	-67	-97
Investment income and gains	4	7	11	16
Net income	257	450	686	1,000
Insurance benefits and claims	-207	-365	-549	-795
Reinsurance recoveries	16	33	49	71
Acquisition costs	-32	-26	-35	-38
Marketing and admin expenses	-314	-250	-225	-200
Reinsurance expense recoveries	91	72	65	58
Trfs from Assets/Liabs under ins contracts	-25	-44	-67	-97
Expenses	-471	-579	-762	-1,001
Profit from operations	-214	-130	-76	-1

Source: UBS estimates

Valuation

As we have done for other parts of the group, we would normally calculate an adjusted embedded value for this business. However, as Discovery does not

disclose embedded values for this business, we have used a discounted cash flow model. Our valuation for Discovery's share of PruHealth and assumptions are detailed in Table 31.

Table 31: PruHealth valuation

Assumptions								
RDR	10%							
Terminal growth rate	2%							
PV of profits at (Rm)	**Pre-tax total**	**Post-tax total**	**FY08**	**FY09**	**FY10**	**FY11**	**FY12**	**Terminal value**
30/06/2008	1,227	859	-130	-69	-1	55	102	1,269
30/06/2009	1,492	1,045	-	-76	-1	61	112	1,396
30/06/2010	1,725	1,207	-	-	-1	67	123	1,536
30/06/2011	1,899	1,329	-	-	-	74	135	1,690
30/06/2012	2,007	1,405	-	-	-	-	149	1,859

Source: UBS estimates

PruProtect (0% of the SOTP)

PruProtect to try to mimic SA life success

PruProtect is the new "risk" life insurance product company within the PruProtection JV in the UK. The concept behind PruProtect is the same as the Discovery Life model built in South Africa.

Half a success better than full ownership of a failure

With the launch of PruProtect, the company can now offer a pure risk life product to compete in the market space where Prudential has struggled in the past five years. They have therefore taken the view that they are more likely to be more successful with the JV with Discovery, than they would be trying to reinvent their risk products again.

Vitality already has critical mass, thanks to PruHealth

We believe that the incorporation of the Vitality programme already in use with PruHealth means this business will assist the JV to build the critical mass required to sustain the Vitality programme in the UK. Furthermore, the fact that Vitality is already in place (with c142k members) on the health side, means that the life business can effectively benefit by not having to start a Vitality programme with little or no members.

As a result of the Vitality usage, and the selection effect of policyholders who want to actively engage in Vitality, we expect that the API margins will be higher than the typical margins in the UK insurance industry. Again, we think PruProtect will attract the healthier individual, resulting in higher risk profits, and also better retain those policyholders who are engaged in Vitality, resulting in better lapse experience, and the resultant increased profitability.

10% new business target aggressive

PruProtect is targeting 10% of the UK protection new business market share in the next two to three years. We think this is aggressive, and are more cautious on our assumed take-up rates. The UK protection market is dominated (c50% of sales) by mortgage cover mostly sold via banking institutions. This market, in our opinion, is largely relationship driven and not that price sensitive. Further c30% of protection sales are designed for estate planning purposes, which would typically be sold through a tax planner/advisor.

We therefore believe that despite the competitiveness of its premium rates, Discovery may struggle to break into these two channels. Nonetheless, we do believe PruProtect will be successful at gaining c5-7% of the new business market in the medium term. Table 32 details our API sales gross premium forecasts for this business.

Table 32: Forecast PruProtect premium income

(Rm)	2008E	2009E	2010E	2011E	2012E
Gross actual premiums earned	75	289	780	1,510	2,382
New business premiums (API)	149	370	786	1,010	1,262

Source: UBS estimates

Earnings forecast

We forecast the earnings of PruProtect on an IFRS basis as detailed in Table 33. (Note that this is the forecast for the whole of PruProtect, i.e. both Discovery's and Prudential's share). In our view, IFRS earnings will be negative in the medium term as it grows new business due to the large up-front acquisition costs inherent in protection business in the UK.

Table 33: PruProtect IFRS earnings forecast

(Rm)	2007	2008E	2009E	2010E
Income statement	-			
Insurance premium income	-	75	289	780
Reinsurance premiums	-	-15	-58	-156
Investment income and gains	-	4	17	47
Net income	-	64	249	671
Insurance benefits and claims	-	-45	-173	-468
Reinsurance recoveries	-	12	46	125
Acquisition costs	-	-208	-555	-1,179
Marketing and admin expenses	-72	-200	-200	-200
Trfs from Assets/Liabs under ins contracts	-	146	389	825
Expenses	-72	-295	-494	-897
Profit from operations	-72	-231	-245	-226

Source: UBS estimates

Valuation

We would normally calculate an adjusted appraisal value for this life business as we have done with the rest of the group. However, as this business has just started, the group does not publish an embedded value for the business.

Also, until we see some evidence of success in this market, we have decided to take the cautious view to value the business at zero at this stage.

Destiny Health (c-2% of the SOTP)

Destiny holding back the share price

We believe that the Destiny Health business is one of the key factors holding back the market price of the Discovery group. Since its launch, Destiny has been a disappointment for shareholders for a variety of reasons.

Suffered from the same factors they benefit from in SA

Firstly, the inability to compete with the incumbent (larger) networks because of its small scale meant that it was unable to secure provider discounts (in the same way in which the benefit in South Africa). Initially when it entered the US, the margins between big and small players were not as wide as they have recently become.

Secondly it struggled to lure business away from other providers because of broker contingent commissions creating a situation where brokers are less likely to move their clients to a new provider as they will lose ongoing "contingent" commissions from the original provider.

Discovery has issued cautionary announcements on the Stock Exchange News Service saying that it is considering Destiny's future strategy and shareholders will be advised as soon as a decision has been made.

"Final" deadline to provide clarity missed

Management had indicated at the year-end results presentation that a final decision would be made in this regard by the middle of October. This deadline has passed, and we believe that the lack of clarity here has held back the share price.

We see three options

We believe that the following options are being considered:

(a) Sell the business as it currently stands

(b) Cease writing business and convert the business into a admin-only business, providing administration out of South Africa to health players in the US

(c) Cease writing business and convert the business into one that sells and administers the Vitality wellness programme to other life and health providers in the US.

In our view, selling the business as it is is not a likely option. We believe that Discovery still aspires to have a successful business in the US, and as such exiting this market completely would not serve this purpose. Further, it would be akin to admitting defeat, not a strategy we believe management will be willing to do.

We believe that options (b) and (c) are far more likely. However, we are not convinced that option (b) is viable given the large time difference between the US and SA, which would make it difficult to administer and underwrite claims and payments.

We think Vitality has potential in the US as a standalone business

Option (c), however, would not be as affected by the time zone difference in that we believe that the administration of Vitality involves less direct client interaction and more automated or internet-based processes. We therefore believe that this is the most likely outcome of the strategic investigation.

Further, this provides Discovery with a unique offering in the US, and one that cannot easily be replicated without the intellectual capital and historical data that Vitality already possesses from its South African experience.

Earnings forecast

We have not assumed any outcome from the investigation in our modelling and continue to project earnings on the current business as it stands, until such time as a decision in made public.

Our earnings forecast on an IFRS basis therefore still shows losses in this business going forward, as detailed in Table 34.

Table 34: Destiny Health IFRS earnings forecast

(Rm)	2007	2008E	2009E	2010E
Income statement				
Insurance premium income	921	1,015	1,066	1,119
Reinsurance premiums	-65	-72	-75	-79
Investment income and gains	13	14	15	16
Net income	869	958	1,006	1,056
Insurance benefits and claims	-707	-762	-778	-806
Reinsurance recoveries	64	54	55	57
Acquisition costs	-44	-49	-51	-53
Marketing and admin expenses	-256	-274	-291	-308
Trfs from Assets/Liabs under ins contracts	-15	-17	-17	-18
Expenses	-958	-1,047	-1,082	-1,129
Profit from operations	-89	-89	-76	-73

Source: UBS estimates

Valuation

As the future of this business is uncertain and the current financial position is loss making, we have taken a cautious view in valuing the business and have used a PE multiple of 5x our full-year losses (see Table 35).

As a cross check, we have estimated a run-off loss projection as the sum of our three-year discounted cash flow of losses plus 2x our estimate of the current salary expense of Destiny. We expect that this is a worst-case scenario as we do believe that action would be taken to shut down this business within the three-year period should a profitable strategy not be found.

Table 35: Destiny valuation summary

(Rm)	FY 08E	FY 09E
Full year Earnings (pre tax)	-88.96	-76.46
PE multiple	5.00	5.00
	-445	-382
Cross check		
PV of 3-year cash flow	-208	-193
2x estimated annual salary roll	-245	-245
Total	-453	-438

Source: UBS estimates

Appendix 1: Detailed IFRS income statement

Table 36: IFRS income statement

(Rm)	2007	2008E	2009E	2010E	2011E	2012E
Income statement						
Insurance premium income	3,710	5,719	8,007	9,645	11,632	13,823
Reinsurance premiums	-593	-766	-995	-1,284	-1,634	-2,021
Fee income from administration business	2,142	2,308	2,537	2,798	3,114	3,463
Investment Income and gains	521	466	810	1,208	1,674	2,207
Vitality income	721	760	802	844	890	938
Net income	6,501	8,487	11,160	13,211	15,675	18,410
Insurance benefits and claims	-1,919	-2,659	-3,361	-4,312	-5,513	-6,849
Reinsurance recoveries	475	606	786	1,014	1,291	1,596
Acquisition costs	-1,015	-1,300	-1,874	-2,622	-3,075	-3,586
marketing and admin expenses	-3,069	-3,392	-3,789	-4,109	-4,491	-4,907
reinsurance expense recoveries	91	72	65	58	58	58
Trfs from Assets/Liabs under ins contracts	587	-265	-1,062	-859	-903	-955
Fair value adj to liabs under inv contracts	-141	-76	-94	-117	-144	-177
Expenses	-4,991	-6,914	-9,328	-10,946	-12,777	-14,819
Profit from operations	1,510	1,573	1,832	2,264	2,876	3,591
BEE expenses	-34	-17	-10	-5	-1	0
Finance costs	-21	-21	-21	-21	-21	-21
Forex Gain - unrealised	3	0	0	0	0	0
Share on profit of associate	0	0	0	0	0	0
Profit before tax	1,458	1,535	1,801	2,238	2,876	3,570
Tax	-385	-461	-540	-672	-863	-1,071
Profit for the year	1,073	1,075	1,260	1,567	2,013	2,499
Effective tax rate	-26%	-30%	-30%	-30%	-30%	-30%
Fully diluted EPS	196	196	230	286	368	457
Headline adjustments						
Realised capital gains on held for sale investments	-187	-70	-92	-126	-172	-231
Headline earnings	886	1,004	1,168	1,441	1,841	2,268
Headline EPS	165	186	217	267	342	42
Interim div	16	18	21	26	33	40
Final div	21	24	27	34	43	53

Source: UBS estimates

Appendix 2: Detailed EV earnings forecast

Table 37: Detailed Embedded value earnings breakdown

	2007	2008E	2009E	2010E	2011E	2012E
Closing embedded value	12,826	15,286	18,220	21,682	25,765	30,545
Opening embedded value	10,587	12,826	15,286	18,220	21,682	25,765
Change in embedded value	2,239	2,466	2,934	3,462	4,082	4,781
net issue of capital	-45	-	-	-	-	-
Dividends paid	239	227	264	325	416	512
realised loss on minority buy back	1	-	-	-	-	-
Transfer to hedging reserve	6	-	-	-	-	-
Embedded value earnings	2,440	2,687	3,197	3,787	4,498	5,292
Return on EV	20.8%	19.1%	19.1%	19.0%	19.0%	18.8%
Return on open EV	23.0%	21.0%	20.9%	20.8%	20.8%	20.5%
Return on EV breakdown						
Opening EV	10,587	12,826	15,286	18,220	21,682	25,765
Value of new business	685	805	878	961	1,042	1,131
Expected return on EV	1,030	1,208	1,433	1,684	1,962	2,269
Change in methodology and assumptions	-13	-	-	-	-	-
Experience variances	553	631	723	824	934	1,056
Removal of Destiny EV	-5	-	-	-	-	-
Destiny health and other new initiative costs	-338	-217	-161	-93	36	185
Acquisition costs	-27	-	-	-	-	-
Adj for minority interest in destiny	-	-	-	-	-	-
Adjustment for Guardian profit share in Destiny	-	-	-	-	-	-
Exchange rate movements	3	-	-	-	-	-
Cost of STC	16	-	-	-	-	-
Return on shareholders funds	536	260	324	412	524	651
closing EV before capital movements	13,027	15,513	18,484	22,007	26,180	31,057
net issue of capital	45	-	-	-	-	-
Dividends paid	-239	-227	-265	-325	-416	-512
realised loss on minority buy back	-1	-	-	-	-	-
Transfer to hedging reserve	-6	-	-	-	-	-
Closing EV	12,826	15,286	18,220	21,682	25,765	30,545

Source: UBS estimates

Discovery Holdings Ltd

Discovery is a financial services company, based in South Africa. It specialises in healthcare coverage, life assurance, and lifestyle and wellbeing benefits. Locally, the company focuses on the health and life insurance markets, and the lifestyle and wellness products and benefits segments. Internationally, Pru HVP offers life and health insurance in the UK market, while Destiny Health offers health insurance in the US market. Vitality forms the foundation of all Discovery's businesses. Discovery Holdings was listed on the JSE in 1999.

Statement of Risk

Investing in insurance groups such as Discovery exposes investors to the following primary risks: 1. The underlying performance of various investments made by the insurer, particularly equities, which are most volatile; 2. Inherent guarantees offered by the insurer to policyholders; 3. Regulatory and tax changes; 4. Company disclosure on expected profitability and embedded value of its insurance business, which are based on a large number of assumptions and propriety knowledge.

Analyst Certification

Each research analyst primarily responsible for the content of this research report, in whole or in part, certifies that with respect to each security or issuer that the analyst covered in this report: (1) all of the views expressed accurately reflect his or her personal views about those securities or issuers; and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by that research analyst in the research report.

Required Disclosures

This report has been prepared by UBS Limited, an affiliate of UBS AG. UBS AG, its subsidiaries, branches and affiliates are referred to herein as UBS.

For information on the ways in which UBS manages conflicts and maintains independence of its research product; historical performance information; and certain additional disclosures concerning UBS research recommendations, please visit www.ubs.com/disclosures.

UBS Investment Research: Global Equity Rating Allocations

UBS 12-Month Rating	Rating Category	Coverage[1]	IB Services[2]
Buy	**Buy**	55%	39%
Neutral	**Hold/Neutral**	36%	36%
Sell	**Sell**	8%	20%
UBS Short-Term Rating	**Rating Category**	**Coverage[3]**	**IB Services[4]**
Buy	**Buy**	less than 1%	25%
Sell	**Sell**	less than 1%	50%

1:Percentage of companies under coverage globally within the 12-month rating category.
2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.
3:Percentage of companies under coverage globally within the Short-Term rating category.
4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

Source: UBS. Rating allocations are as of 31 December 2007.

UBS Investment Research: Global Equity Rating Definitions

UBS 12-Month Rating	Definition
Buy	FSR is > 6% above the MRA.
Neutral	FSR is between -6% and 6% of the MRA.
Sell	FSR is > 6% below the MRA.
UBS Short-Term Rating	**Definition**
Buy	Buy: Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.
Sell	Sell: Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.

KEY DEFINITIONS

Forecast Stock Return (FSR) is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months.
Market Return Assumption (MRA) is defined as the one-year local market interest rate plus 5% (a proxy for, and not a forecast of, the equity risk premium).
Under Review (UR) Stocks may be flagged as UR by the analyst, indicating that the stock's price target and/or rating are subject to possible change in the near term, usually in response to an event that may affect the investment case or valuation.
Short-Term Ratings reflect the expected near-term (up to three months) performance of the stock and do not reflect any change in the fundamental view or investment case.

EXCEPTIONS AND SPECIAL CASES

UK and European Investment Fund ratings and definitions are :
Buy: Positive on factors such as structure, management, performance record, discount; Neutral: Neutral on factors such as structure, management, performance record, discount; Sell: Negative on factors such as structure, management, performance record, discount.
Core Banding Exceptions (CBE) : Exceptions to the standard +/-6% bands may be granted by the Investment Review Committee (IRC). Factors considered by the IRC include the stock's volatility and the credit spread of the respective company's debt. As a result, stocks deemed to be very high or low risk may be subject to higher or lower bands as they relate to the rating. When such exceptions apply, they will be identified in the Company Disclosures table in the relevant research piece.

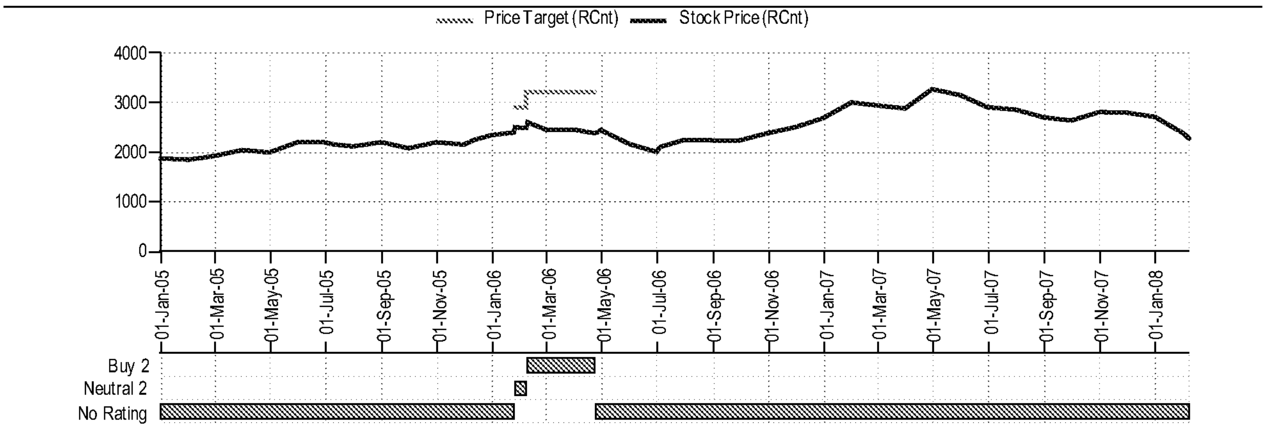
Company Disclosures

Company Name	Reuters	12-mo rating	Short-term rating	Price	Price date
Discovery Holdings Ltd	DSYJ.J	Not Rated	N/A	RCnt2,272	07 Feb 2008

Source: UBS. All prices as of local market close.
Ratings in this table are the most current published ratings prior to this report. They may be more recent than the stock pricing date

Unless otherwise indicated, please refer to the Valuation and Risk sections within the body of this report.

Discovery Holdings Ltd (RCnt)



Source: UBS; as of 07 Feb 2008

Note: On August 4, 2007 UBS revised its rating system. (See 'UBS Investment Research: Global Equity Rating Definitions' table for details). From September 9, 2006 through August 3, 2007 the UBS ratings and their definitions were: Buy 1 = FSR is > 6% above the MRA, higher degree of predictability; Buy 2 = FSR is > 6% above the MRA, lower degree of predictability; Neutral 1 = FSR is between -6% and 6% of the MRA, higher degree of predictability; Neutral 2 = FSR is between -6% and 6% of the MRA, lower degree of predictability; Reduce 1 = FSR is > 6% below the MRA, higher degree of predictability; Reduce 2 = FSR is > 6% below the MRA, lower degree of predictability. The predictability level indicates an analyst's conviction in the FSR. A predictability level of '1' means that the analyst's estimate of FSR is in the middle of a narrower, or smaller, range of possibilities. A predictability level of '2' means that the analyst's estimate of FSR is in the middle of a broader, or larger, range of possibilities. From October 13, 2003 through September 8, 2006 the percentage band criteria used in the rating system was 10%.

Additional Prices: Liberty Group Limited, RCnt7,300 (07 Feb 2008); Old Mutual Plc, 121p (07 Feb 2008); Old Mutual plc (South Africa), RCnt1,861 (07 Feb 2008); Sanlam Limited, RCnt1,880 (07 Feb 2008); Source: UBS. All prices as of local market close.

Global Disclaimer

This report has been prepared by UBS Limited, an affiliate of UBS AG. UBS AG, its subsidiaries, branches and affiliates are referred to herein as UBS. In certain countries, UBS AG is referred to as UBS SA.

This report is for distribution only under such circumstances as may be permitted by applicable law. Nothing in this report constitutes a representation that any investment strategy or recommendation contained herein is suitable or appropriate to a recipient's individual circumstances or otherwise constitute a personal recommendation. It is published solely for information purposes, it does not constitute an advertisement and is not to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments in any jurisdiction. No representation or warranty, either express or implied, is provided in relation to the accuracy, completeness or reliability of the information contained herein, except with respect to information concerning UBS AG, its subsidiaries and affiliates, nor is it intended to be a complete statement or summary of the securities, markets or developments referred to in the report. UBS does not undertake that investors will obtain profits, nor will it share with investors any investment profits nor accept any liability for any investment losses. Investments involve risks and investors should exercise prudence in making their investment decisions. The report should not be regarded by recipients as a substitute for the exercise of their own judgement. Any opinions expressed in this report are subject to change without notice and may differ or be contrary to opinions expressed by other business areas or groups of UBS as a result of using different assumptions and criteria. Research will initiate, update and cease coverage solely at the discretion of UBS Investment Bank Research Management. The analysis contained herein is based on numerous assumptions. Different assumptions could result in materially different results. The analyst(s) responsible for the preparation of this report may interact with trading desk personnel, sales personnel and other constituencies for the purpose of gathering, synthesizing and interpreting market information. UBS is under no obligation to update or keep current the information contained herein. UBS relies on information barriers to control the flow of information contained in one or more areas within UBS, into other areas, units, groups or affiliates of UBS. The compensation of the analyst who prepared this report is determined exclusively by research management and senior management (not including investment banking). Analyst compensation is not based on investment banking revenues, however, compensation may relate to the revenues of UBS Investment Bank as a whole, of which investment banking, sales and trading are a part.

The securities described herein may not be eligible for sale in all jurisdictions or to certain categories of investors. Options, derivative products and futures are not suitable for all investors, and trading in these instruments is considered risky. Mortgage and asset-backed securities may involve a high degree of risk and may be highly volatile in response to fluctuations in interest rates and other market conditions. Past performance is not necessarily indicative of future results. Foreign currency rates of exchange may adversely affect the value, price or income of any security or related instrument mentioned in this report. For investment advice, trade execution or other enquiries, clients should contact their local sales representative. Neither UBS nor any of its affiliates, nor any of UBS' or any of its affiliates, directors, employees or agents accepts any liability for any loss or damage arising out of the use of all or any part of this report. Additional information will be made available upon request.

For financial instruments admitted to trading on an EU regulated market: UBS AG, its affiliates or subsidiaries (excluding UBS Securities LLC and/or UBS Capital Markets LP) acts as a market maker or liquidity provider (in accordance with the interpretation of these terms in the UK) in the financial instruments of the issuer save that where the activity of liquidity provider is carried out in accordance with the definition given to it by the laws and regulations of any other EU jurisdictions, such information is separately disclosed in this research report.

United Kingdom and the rest of Europe: Except as otherwise specified herein, this material is communicated by UBS Limited, a subsidiary of UBS AG, to persons who are eligible counterparties or professional clients and is only available to such persons. The information contained herein does not apply to, and should not be relied upon by, retail clients.. UBS Limited is authorised and regulated by the Financial Services Authority (FSA). UBS research complies with all the FSA requirements and laws concerning disclosures and these are indicated on the research where applicable. **France:** Prepared by UBS Limited and distributed by UBS Limited and UBS Securities France SA. UBS Securities France S.A. is regulated by the Autorité des Marchés Financiers (AMF). Where an analyst of UBS Securities France S.A. has contributed to this report, the report is also deemed to have been prepared by UBS Securities France S.A. **Germany:** Prepared by UBS Limited and distributed by UBS Limited and UBS Deutschland AG. UBS Deutschland AG is regulated by the Bundesanstalt fur Finanzdienstleistungsaufsicht (BaFin). **Spain:** Prepared by UBS Limited and distributed by UBS Limited and UBS Securities España SV, SA. UBS Securities España SV, SA is regulated by the Comisión Nacional del Mercado de Valores (CNMV). **Turkey:** Prepared by UBS Menkul Degerler AS on behalf of and distributed by UBS Limited. **Russia:** Prepared and distributed by ZAO UBS Securities. **Switzerland:** Distributed by UBS AG to persons who are institutional investors only. **Italy:** Prepared by UBS Limited and distributed by UBS Limited and UBS Italia Sim S.p.A.. UBS Italia Sim S.p.A. is regulated by the Bank of Italy and by the Commissione Nazionale per le Società e la Borsa (CONSOB). Where an analyst of UBS Italia Sim S.p.A. has contributed to this report, the report is also deemed to have been prepared by UBS Italia Sim S.p.A.. **South Africa:** UBS South Africa (Pty) Limited (Registration No. 1995/011140/07) is a member of the JSE Limited, the South African Futures Exchange and the Bond Exchange of South Africa. UBS South Africa (Pty) Limited is an authorised Financial Services Provider. Details of its postal and physical address and a list of its directors are available on request or may be accessed at http:www.ubs.co.za. **United States:** Distributed to US persons by either UBS Securities LLC or by UBS Financial Services Inc., subsidiaries of UBS AG; or by a group, subsidiary or affiliate of UBS AG that is not registered as a US broker-dealer (a '**non-US affiliate**'), to major US institutional investors only. UBS Securities LLC or UBS Financial Services Inc. accepts responsibility for the content of a report prepared by another non-US affiliate when distributed to US persons by UBS Securities LLC or UBS Financial Services Inc. All transactions by a US person in the securities mentioned in this report must be effected through UBS Securities LLC or UBS Financial Services Inc., and not through a non-US affiliate. **Canada:** Distributed by UBS Securities Canada Inc., a subsidiary of UBS AG and a member of the principal Canadian stock exchanges & CIPF. A statement of its financial condition and a list of its directors and senior officers will be provided upon request. **Hong Kong:** Distributed by UBS Securities Asia Limited. **Singapore:** Distributed by UBS Securities Pte. Ltd or UBS AG, Singapore Branch. **Japan:** Distributed by UBS Securities Japan Ltd to institutional investors only. **Australia:** Distributed by UBS AG (Holder of Australian Financial Services Licence No. 231087) and UBS Securities Australia Ltd (Holder of Australian Financial Services Licence No. 231098) only to 'Wholesale' clients as defined by s761G of the Corporations Act 2001. **New Zealand:** Distributed by UBS New Zealand Ltd. **China:** Distributed by UBS Securities Co. Limited.

The disclosures contained in research reports produced by UBS Limited shall be governed by and construed in accordance with English law.

UBS